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REPORT AND RECOMMENDATION

OF THE

PRESIDENT OF THE

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

TO THE EXECUTIVE DIRECTORS

ON A

PROPOSED SECOND STRUCTURAL ADJUSTMENT LOAN

IN AN AMOUNT EQUIVALENT TO US$2.0 BILLION

TO THE REPUBLIC OF KOREA

October 2, 1998

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CURRENCY EQUIVALENTS
(As of September 29, 1998)

Currency Unit	=	Won (W)
$1.00	=	W1,370
W1.00	=	$0.0007

ABBREVIATIONS

ALM	-	Asset Liability Management
ASEM	-	Asia-Europe Meeting Trust Fund
BIS	-	Bank for International Settlements
BOK	-	Bank of Korea
Chaebols	-	Conglomerates
CRA	-	Corporate Restructuring Agreement
CRCC	-	Corporate Restructuring Coordinating Committee
CRV	-	Corporate Restructuring Vehicle
EIS	-	Employment Insurance System
ERL	-	Economic Reconstruction Loan
FCRAL	-	Financial and Corporate Restructuring Assistance Loan
FSB	-	Financial Supervisory Board
FSC	-	Financial Supervisory Commission
FTA	-	Fair Trade Act
GDP	-	Gross Domestic Product
GOK	-	Government of Korea
IDF		Institutional Development Fund
IMF	-	International Monetary Fund
IPO	-	Initial Public Offering
KAMC	-	Korean Asset Management Corporation
KDIC	-	Korean Deposit Insurance Corporation
KEPCO	-	Korea Electric Power Corporation
KFTC	-	Korean Fair Trade Commission
KICPA	-	Korean Institute of Certified Public Accountants
KOGAS	-	Korea Gas Corporation
KOSDAQ	-	Korea Securities Dealers Association
KSE	-	Korea Stock Exchange
LDP	-	Letter of Development Policy
M&A	-	Mergers and Acquisitions
MOFE	-	Ministry of Finance and Economy
MSB	-	Monetary Stabilization Bond
NPS	-	National Pension Scheme
OBS	-	Office of Banking Supervision
OECD	-	Organization for Economic Corporation and Development
PCA	-	Prompt Corrective Action Procedures
SAL	-	Structural Adjustment Loan
SCL	-	Single Currency Loan
SME	-	Small and Medium Enterprise
SOE	-	State Owned Enterprise
SCE	-	State Capitalized Enterprise
SIE	-	State Invested Enterprise
SRO	-	Self Regulatory Organizations
TA	-	Technical Assistance
TAL	-	Technical Assistance Loan
TOR	-	Terms of Reference
WTO	-	World Trade Organization

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REPUBLIC OF KOREA
SECOND STRUCTURAL ADJUSTMENT LOAN

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REPUBLIC OF KOREA
SECOND STRUCTURAL ADJUSTMENT LOAN

LOAN AND PROGRAM SUMMARY

Borrower: Republic of Korea.

Amount and terms: US$2.0 billion—Single Currency Loan in US Dollars for 15 years including 5 years' grace, at an interest rate of 6-month US Dollar LIBOR (reset semiannually) plus 75 basis points, and with a service charge of 1.5 percent of the loan amount payable on effectiveness.

Description: The proposed second structural adjustment loan (SAL II) is part of a series of World Bank adjustment loans in support of the major structural reform program that the Government of Korea has launched in response to the economic crisis. It builds on the work initiated under an Economic Reconstruction Loan approved on December 23, 1997, and continued under a Structural Adjustment Loan (SAL I) approved on March 26, 1998. The proposed SAL II will help Korea restore financial stability while mitigating the social costs of adjustment, and implement deep structural reforms in the financial and corporate sectors to pave the way for Korea's return to strong and sustained growth. The loan is part of an internationally coordinated support package for Korea.

SAL II calls for macroeconomic policies designed to mitigate the severity of the recession while consolidating the progress made in strengthening the external financial position, within the framework of the macroeconomic program agreed with the IMF. The structural reform program it supports spans three key areas: financial sector reform, including the resolution of weak financial institutions, strengthening of prudential regulation and supervision, and capital market development; corporate sector reform, including corporate debt restructuring, reform of corporate governance and competition policies, and reform and privatization of state-owned corporations; and labor market reform and strengthening of social safety nets. The Government's commitment to the reform program supported by the loan is set out in the Policy Matrix (Annex 1).

Benefits and risks: **Benefits**. Besides helping Korea overcome its external financial crisis and restore investor confidence, the proposed loan will support a program of major structural reforms aimed at bringing about a fundamental restructuring of the incentives and institutional framework to underpin financial sector stability, restructure corporate finances, improve corporate efficiency and competitiveness, and enable Korea to return to a path of robust growth in the context of today's more integrated and competitive global economy. The loan will support policies to cushion the impact of the crisis and economic restructuring on the poor and the vulnerable as well as make lasting improvements in Korea's system of social protection. The region, and the international financial system at large, also would benefit from an early restoration of market confidence and recovery of growth in Korea.

Risks. Despite progress, investor confidence remains fragile and the external position is still vulnerable to major shocks. There are risks in the external environment, especially related to the regional situation, e.g., developments in Japan. Mitigating these risks is the firmness the Government has demonstrated in implementing tough macroeconomic policies, which inspires confidence in its macroeconomic crisis response ability. The implementation of the IMF program is on track. The rebuilding of international reserves since the crisis also provides a cushion against shocks, as does the restructuring of foreign liabilities toward longer maturities. The provision of additional adjustment financing by the Bank through the proposed loan, and the structural reforms conducive to restoration of Korea's competitiveness and foothold in export markets that the loan would support, would provide further comfort to markets.

The fragility of the banking system and high corporate leverage are major sources of vulnerability in the Korean economy. Addressing these vulnerabilities through financial and corporate sector restructuring forms the core of the SAL II program. The required restructuring, however, will be a difficult process and risks of slippage cannot be ignored. The risks arise from several factors: pressures from vested interests that militate against deep restructuring and could lead instead to a "muddle-through" approach; inefficient, non-transparent use of public resources that accentuates moral hazard and results in large fiscal costs without achieving meaningful, durable restructuring; weak financial system and corporate governance; and inadequate implementation capacities. The proposed program mitigates these risks by putting in place a clear, monitorable framework for financial and corporate sector restructuring, building in appropriate incentives and safeguards; setting out clear criteria for public resource use; supporting complementary actions to improve financial system and corporate governance; and providing technical assistance to both supervisory authorities and units in banks specially set up to negotiate corporate debt workouts (supported by the Financial and Corporate Restructuring Assistance Loan approved on August 6, 1998).

Political factors may also hinder reform: shifts in the balance of power between the ruling and opposition parties; severity of the economic downturn causing political support for reform to unravel; increasing labor union militancy as unemployment rises; and a premature sense of complacency as the external financial situation improves. The strong commitment to reform demonstrated by the Government so far, reflected in the implementation of major and politically difficult reforms, provides assurance against these risks. Union militancy has increased, but union actions so far have failed to attract wider public support and the Government has committed to stand firm in defense of its pro-reform agenda. The Government, supported by the Bank program, is taking a number of measures to strengthen the social safety net, and has followed a participatory approach in designing policy responses within a tripartite forum bringing together government, business and labor representatives, measures that contribute to preserving the social consensus for reform.

Poverty category: N.A.

Disbursements: The loan would be disbursed in two equal tranches, the first upon effectiveness and the second upon satisfaction of second tranche release conditions.

Project ID Number: KR-PE-56521

REPUBLIC OF KOREA

SECOND STRUCTURAL ADJUSTMENT LOAN

The proposed loan is a second World Bank structural adjustment loan (SAL II) in support of the Republic of Korea's program of structural reforms. It builds upon the work initiated under an Economic Reconstruction Loan (ERL) approved by the Board on December 23, 1997 in an amount of $3 billion, and continued under a structural adjustment loan (SAL I) approved on March 26, 1998 in an amount of $2 billion. The program supported by the proposed loan aims to deepen reforms in the priority areas of financial sector restructuring, corporate sector restructuring, and strengthening of social safety nets. Its goal is to assist Korea in the restoration of financial stability while mitigating the social impact of the crisis and support structural reforms that address the root causes of the crisis and lay the basis for Korea's return to strong and sustainable growth.

The proposed loan is a two-tranche, fast-disbursing operation. The loan amount is $2 billion, divided equally into two tranches. The proposed loan is grounded in a medium-term strategic framework for support to Korea's structural reform program, and is part of the international financing package for Korea agreed in December 1997. The Bank undertook to provide up to $10 billion in support of Korea's structural reforms as part of that package.

I. MACROECONOMIC DEVELOPMENTS, POLICIES AND PROSPECTS

1.1 **Recent Developments.** Korea has made considerable progress in stabilizing its external financial position. However, the downturn in the domestic economy has been severe. The central challenge for macroeconomic policy now is to mitigate the severity of the recession and facilitate an economic recovery while consolidating the progress in restoring external financial stability.

1.2 In response to the crisis, Korea has implemented a strong macroeconomic program designed to restore stability in the foreign exchange market, rebuild international reserves, and contain potential inflationary pressures resulting from the economic shocks. Macroeconomic policies designed within the framework of an IMF stand-by program involved a sharp tightening of monetary policy (reflected in a rise in benchmark interest rates from a pre-crisis level of around 12 percent to 30 percent) as well as some fiscal tightening. The stance of these macroeconomic policies has been progressively eased during the course of the year as stability returned to the foreign exchange market but also in response to a domestic economic downturn that turned out to be much sharper than initially projected. Korea has also been implementing a structural reform program to address the underlying causes of the crisis and pave the way for an eventual return to robust growth. Supported by Bank adjustment loans, the structural reform program focuses on financial and corporate sector restructuring and policies to mitigate the social impact of the crisis.

1.3 Over the past three months or so, Korea has seen a significant improvement in its external financial position. The Won exchange rate has recently hovered around W1350 to the US dollar, having recovered from a low of W1960 reached in December 1997 at the height of the financial crisis. The current account balance has adjusted dramatically. Much of the improvement in the trade balance has been on account of a compression of imports, but there has also been an export volume response. A current account surplus of $37-40 billion is now projected for 1998 (representing a swing from a deficit of 1.9 percent of GDP in

1997 to a surplus of 12-13 percent). As of mid-September, gross usable reserves stood at about $42 billion, having recovered from a low of $4 billion at the peak of the crisis. The maturity structure of external debt has been improved, with the short-term external debt reduced to about $40 billion from $68 billion at end-1997 (and about $100 billion in 1996). Detailed data on macroeconomic developments and projections are presented in Annex 2, Tables 1-6.

1.4 While developments on the external front have been encouraging, the recession in the domestic economy has deepened. Projections of output growth have been revised downwards several times over the past few months, and GDP is now expected to decline by about 7 percent in 1998. Mirroring the contraction in output, unemployment has risen sharply. The open unemployment rate was estimated at 7.4 percent in August, up from about 3 percent before the crisis, and is expected to rise further with the deepening of the recession. More layoffs are inevitable as larger corporations and financial institutions undertake fuller restructuring; so far layoffs have been concentrated in small and medium-size enterprises. Likewise, the stock market has weakened considerably, losing all of its post-crisis gain. The stock market index is now well below the low reached in December 1997.

1.5 An economic downturn was inevitable as a result of the crisis and the macroeconomic policy tightening implemented in response, but the recession has proved to be more severe than originally projected for several reasons. First, there has been a large drop in domestic demand, led initially by a sharp decline in investment and intensified more recently by a drop in private consumption. The fall in private demand was exacerbated by a contractionary fiscal policy. Second, financial and corporate sector distress is deep and widespread. Given the very high leverage of Korea's corporate sector, corporate financial positions, and consequently also the health of the portfolios of creditor financial institutions, are particularly vulnerable to interest rate spikes. The decline in economic activity and corporate and financial sector distress have reinforced each other (Box 1). Third, the regional contagion effect and the simultaneous contraction of economic activity in other East Asian countries has dampened the potential for a significant export-led recovery. Roughly one-half of Korea's exports are within Asia.

1.6 Exports provided a stimulus to aggregate demand in the first quarter of this year, helping to offset some of the decline in domestic demand. Although in (US dollar) value terms exports grew only by 3 percent year on year in the first quarter of 1998, export volume growth (excluding one-time gold sales) was around 20 percent. Export growth, however, started to slow in the second quarter, and is likely to slow further for several reasons. First, as the scope for inventory draw-down declines, constraints in trade financing would become more binding. Second, declining demand in the rest of Asia, together with the appreciation of the Won on the one hand and the depreciation of partner country currencies on the other, could dampen export growth.[1] A significant further depreciation of the Japanese Yen, in particular, could have a sizable effect on Korea's exports. Japan is both a significant importer from Korea and a competitor in third markets.

1.7 Small and medium enterprises (SMEs), which account for around 40 percent of Korea's exports and the bulk of employment, are particularly affected by a credit crunch. The Government has taken several steps to mitigate the impact—an expanded official export credit guarantee scheme, a central bank refinancing scheme for Won-denominated loans to exporters, a limited rollover of maturing SME debt to

[1] At the peak of the financial crisis, Korea's real effective exchange rate had depreciated by more than 40 percent from pre-crisis levels. Since then it has appreciated by about 25 percent. While the real effective exchange rate remains 15-18 percent depreciated from pre-crisis levels, the scope for further real appreciation is now more limited, increasing Korea's sensitivity to further significant changes in major trading partner exchange rates.

provide a breathing space, and more recently a $3 billion SME import financing scheme and a $300 million SME export financing scheme. While these actions have helped ease SME financial difficulties, a fuller resolution of their problems will depend on a broader resumption of bank lending as well as recovery among larger corporations to which many of the SMEs in Korea have traditionally been financially and commercially linked.

BOX 1: MACROECONOMIC, FINANCIAL AND CORPORATE SECTOR NEXUS

Policy challenges facing Korea have been rendered more complex by the fact that macroeconomic developments and the problems of the corporate and financial sectors have reinforced each other. In particular, the structure and weaknesses of the balance sheets of Korean corporations have made them very vulnerable to changes in key macroeconomic variables, especially interest rates. Korean corporations are very highly leveraged, with the thirty largest conglomerates (*chaebol*) having an average debt-equity ratio of about 520 percent as of end-1997 (600 percent including their financial affiliates). This compares with an industrial country norm of below 200 percent. Total corporate debt is currently estimated to be on the order of $500 billion (more than 150 percent of GDP at current exchange rates), of which around 90 percent is domestic debt.

Given the high indebtedness of Korean corporations, increases in domestic interest rates have a major impact on their financial position. An indication of the cushion firms have in the face of shocks is their interest coverage. The interest coverage (or the ratio of operating income before interest and taxes to net interest payments) of Korean corporations has been declining progressively and was estimated at about 135 percent in 1997. By comparison, interest coverage ratios range from 250-450 percent in other OECD countries. It is estimated that a one percentage point increase in domestic interest rates lowers the interest coverage of Korean corporations by about 3-4 percentage points within a year. Compounding the effect of sharply higher interest rates, and not unrelated to interest rates, has been the plunge in domestic demand, which has affected firms on the earnings side.

High indebtedness and the associated deterioration of corporate financial positions have intensified financial system distress. Financial system non-performing loans have increased rapidly, with the bulk of the increase in bank loans which account for about half of all corporate debt. Non-performing loans, including those classified as such on a precautionary basis, are now approaching 20 percent of all bank loans. In turn, banks, faced with the need to restructure and recapitalize, have sharply reduced new lending and have had to resort to loan recalls. Risk premia on lending to corporations also rose, adding to the pressure on interest rates arising from monetary tightening. The resulting credit crunch has compounded corporate financial problems and depressed economic activity more generally, with its further negative feedback effects on firms and financial institutions.

Given these linkages between macroeconomic developments and financial and corporate sector difficulties, an effective policy response to the present Korean crisis requires simultaneous and mutually supporting actions on all three fronts: macroeconomic policies that mitigate the severity of the recession and support a recovery of domestic demand (while preserving financial stability); speedy progress on the restructuring and recapitalization of the financial system to enable it to resume its financial intermediation role; and a framework to restructure and reduce corporate debt.

1.8 Projections of inflation have also been subject to downward revision. The plunge in domestic demand and the build-up of excess capacity, falling wages associated with increased unemployment, and the recent appreciation of the Won, have dampened pressures on prices. Indeed, consumer prices have fallen at an annual rate of 0.6 percent in the past five months, and inflation for 1998 as a whole is now projected at about 7 percent, down from earlier projections of around 10 percent.

1.9 As stability has returned to the foreign exchange market and inflation pressures have subsided in recent months, interest rates have come down appreciably from the high levels at the beginning of the year.

The overnight call rate stood at about 8.5 percent and the three-year corporate bond yield at 12.5 percent in late September, both rates having declined from peaks of around 30 percent. While this decline is indeed welcome, real interest rates remain relatively high, given the drop in inflation. Also, for most firms, especially SMEs, the interest rates actually charged remain much higher. The availability of credit remains severely constrained for all but the largest firms as financial institutions limit lending to prevent further deterioration of their portfolios.

1.10 **Policies and Prospects**. The emphasis in macroeconomic management now needs to be placed on arresting the decline in domestic demand and paving the way for its revival. This calls for an easing of both monetary and fiscal policies, while keeping a close watch on financial markets to ensure that the hard-won gains in stabilization are preserved. This needs to be complemented by pressing ahead decisively with financial and corporate sector restructuring (structural reform policies are discussed in Section II).

1.11 Monetary policy should utilize the scope for further reductions in interest rates, consistent with continued stability of the exchange rate. As much of the earlier spike in interest rates has been reversed in recent months, the scope for further reductions now is correspondingly less, though still important. As interest rates facing the corporate sector continue to include relatively high risk premia, further reductions will depend not only on the stance of monetary policy but also on progress made on corporate restructuring.

1.12 There is scope also for moderating the economic downturn through an easing of fiscal policy, especially considering Korea's relatively low level of public debt. Even though the target budget balance for 1998 has been progressively relaxed, the fiscal stance remained contractionary in cyclically adjusted terms during the first half of the year, thereby accentuating the contraction in domestic demand. A new supplementary budget passed by the National Assembly in August seeks to correct this situation. An overall central government fiscal deficit of 5 percent of GDP is now projected for 1998, up from a target deficit of 1.7 percent in April. Even with this increase in the deficit, the fiscal stance would be only modestly expansionary in cyclically adjusted terms as the operation of automatic stabilizers would imply a deficit of at least 4 percent of GDP given the projected decline in GDP in 1998. The Government has committed to adopt contingent fiscal measures in the event the economic downturn proves to be still more severe, in order to ensure that the fiscal stance remains supportive of aggregate demand. For 1999, the Government's fiscal plan envisages an overall deficit of 5 percent of GDP, continuing the policy shift toward a fiscal stimulus.

1.13 The expansion of the budget deficit incorporates a significant further increase in spending on social safety nets—unemployment benefits, public works, poverty-targeted programs—to cushion the impact of the crisis on the unemployed and the poor. This increases social safety net outlays in the 1998 budget to W10.4 trillion (2.5 percent of GDP), a near ten-fold increase over 1997. The Government's fiscal plan for 1999 provides for another significant increase of 45 percent in such outlays (details of social safety net programs are provided in Section II D). As part of its contingent fiscal planning, the Government has committed to increase social safety net spending in the event of a further economic slowdown.

1.14 The fiscal stance will also need to be consistent with the fiscal costs associated with financial system restructuring and recapitalization, which are likely to be large (para 2.20). The 1998 budget allocates 0.8 percent of GDP for interest costs of bonds issued in connection with financial sector support. This component is expected to rise in the coming budgets, and could reach around 3 percent of GDP in the medium term (the Government's fiscal plan for 1999 provides for an allocation of 1.9 percent of GDP for this component). A challenge for fiscal policy will be to accommodate this outlay within an overall fiscal stance consistent with broader macroeconomic goals.

1.15 Provided that Korea adheres to sound macroeconomic policies and makes headway with the structural reform agenda, it can return to growth in the 5-6 percent range in the medium term, lower than before the crisis but still robust (see Annex 2, Table 6 for details of medium-term macroeconomic projections). It is the shorter-term outlook that is subject to greater uncertainty. The uncertainties stem both from domestic and external factors. Domestic sources of uncertainty include the degree of severity of the still unfolding economic impact of financial and corporate sector distress, and the political setting which will influence the speed of policy reforms. Externally, the risks arise from the regional crisis and how it will evolve in the coming months, especially the situation in Japan, and the still fragile foreign investor confidence. The response to the domestic risks is to adopt macroeconomic policies more supportive of domestic demand as outlined above, including strong social safety net policies that would help maintain the social and political consensus for reform, and to proceed resolutely with financial and corporate sector restructuring. The response to the external risks is partly the same domestic economic policies that build credibility and enhance foreign investor confidence and partly the attainment of a strong cushion of international reserves and an improved maturity profile of foreign liabilities coupled with continued flexibility in exchange rate policy.

1.16 **External Financing**. Gross usable reserves are targeted to rise to at least $43 billion by year-end, sufficient to cover short-term external debt. Financing provided by the proposed SAL II is part of the overall macroeconomic framework agreed with the IMF to achieve the reserve target, and will supplement financing provided by the IMF and the ADB in the context of the international financing package agreed in December 1997 (see Annex 2, Table 2 for details of external financing requirements). The need for maintaining a strong reserve position in view of the external risks was emphasized above. The continued fragility of investor confidence is underlined by the sharp reversal of private portfolio flows from a net inflow of about $4 billion in the first quarter of 1998 to a net outflow of $3 billion in the second quarter as market sentiment deteriorated, a development mirrored by the parallel sharp reversal of stock market gains. Korea also will face a hump in external debt service in the coming year as repayment of some of the $22 billion short-term debt of Korean financial institutions that was restructured in April this year falls due and Korea makes sizable net repurchases to the IMF. Moreover, the surplus in the current account will decline sharply as imports recover from their recent sharp contraction. The current account surplus is expected to drop in 1999 to about one-half of the level projected for 1998.

1.17 Besides these external financial grounds, there is a fiscal case for Bank adjustment financing, in view of the need to expand the budget deficit to support financial sector restructuring and strengthen social safety nets. As noted above, the overall central government fiscal deficit is projected at 5 percent of GDP in both 1998 and 1999. The fiscal position is likely to remain under pressure in the medium term, as the deficit is expected to decline only gradually after 1999 (Annex 2, Table 6). Financing the deficit partly from foreign borrowing would reduce the need for public borrowing from the domestic market and thereby limit the risk of putting renewed upward pressure on domestic interest rates and of crowding out the private sector from a credit market already disinclined to lend to most private firms.

1.18 Korea has so far made purchases of about $18 billion out of a total of about $21 billion provided under the ongoing IMF stand-by arrangement. The last purchase made was in August, based upon completion of the third quarterly review under this three-year arrangement.

II. THE STRUCTURAL REFORM PROGRAM

2.1 In response to the economic crisis, the Korean Government embarked on a major structural reform program last December. The Bank is supporting this reform program through a series of adjustment loans, starting with a $3 billion Economic Reconstruction Loan (ERL) which was followed by a $2 billion Structural Adjustment Loan (SAL I). Substantial progress has been made in the implementation of the structural reform program, despite a difficult macroeconomic setting and the associated social and political pressures. The Government has shown a firm resolve to press ahead with reforms, in full recognition that the response to the crisis must not just deal with its immediate symptoms but address its root causes.

A. OVERVIEW OF THE STRUCTURAL REFORM PROGRAM

2.2 Korea's economic reform program has two central objectives: restoring macrofinancial stability while limiting the costs to the real economy and the impact on the vulnerable; and strengthening the economy's structural foundation to lay the basis for resumption of robust and sustained growth. The achievement of these objectives requires an economic reform program comprising three main elements:

- implementing prudent, responsive macroeconomic policies;
- maintaining the momentum of reforms that address the underlying structural causes of the crisis, including a radical restructuring of the incentives and institutional framework; and
- strengthening social safety nets.

2.3 Korea's economic record over the past three decades has been impressive, but the recent crisis has revealed vulnerabilities that must be addressed to prepare Korea for continued success in the next stage of development. These vulnerabilities arise partly from internal weaknesses and excesses in the Korean economy—unsound financial system practices and weak regulatory and supervisory framework, high corporate leverage, failure of corporate governance, excessive government intervention in business, policies inhibiting competition, wage increases outstripping productivity growth. The vulnerabilities arise also from external changes that have altered the global context in which the Korean economy operates today—globalization, increased international mobility and potential volatility of capital, more open and competitive international trade markets, emergence of major new competitors (especially China, from Korea's perspective). These changes in the global context both raise potential rewards to reforms that make countries financially more sound and industrially more competitive, as well as increase the price they must pay for failure to act.

2.4 Korea needs a radical restructuring of its incentives and institutional framework to overcome these vulnerabilities and rise to the new challenges, a restructuring that promotes financial system soundness, fosters more sustainable patterns of corporate financing, increases corporations' exposure to market discipline, enhances competition (domestic and foreign), and opens up the labor market to increased flexibility. Such a shift is necessary to restore and sustain financial sector stability, reestablish the corporate sector's financial viability and increase its efficiency, and recover Korea's competitiveness and foothold in export markets. The Korean economy has well-known strengths—a large stock of human skills, technology and industrial capital accumulated over several decades of growth, and strong habits of thrift and hard work. An improved incentives and institutional framework, more attuned to today's economic imperatives, would allow Korea to effectively reengage and redeploy these strengths and reemerge as strong and successful in the medium term as it has been in the past.

2.5 It is this strategic vision that underpins the medium-term structural reform program that the Government of Korea has embarked on and is implementing in close cooperation with the World Bank. SAL I (and the ERL) supported the first stage of this reform program, focusing on three key areas: financial sector restructuring and development; corporate restructuring and reform of corporate governance and competition policies; and labor market reform and strengthening of social safety nets. Spanning the financial and corporate sectors and the labor market, the reform program captures the core of Korea's restructuring challenges. Its implementation will fundamentally alter the incentives and institutional framework influencing the behavior of all key actors in the economy—banks, enterprises, labor, policy makers. At the same time, the program provides for a major strengthening of Korea's system of social protection, to cushion the impact of the crisis and structural transformation on the poor and the vulnerable.

2.6 A strong start has been made on this reform program under SAL I. The agenda for SAL I provided for a substantial front-loading of reform. It required a number of key actions to be taken prior to Board presentation (29 in all), many of which were implemented through a major package of legislation passed by the National Assembly in February 1998.[2] The reform effort has continued since with the implementation of additional measures envisaged in SAL I.

2.7 The proposed SAL II will support the next stage of the Government's medium-term structural reform program. It maintains the focus on the same three core areas of reform—financial, corporate and social sectors—with the objective of deepening and extending the reforms in these areas. SAL II, therefore, provides continuity with SAL I, and will build on the important progress made under that loan. The structural reform effort will be underpinned by implementation of macroeconomic policies that are supportive of financial stability and restoration of growth (as discussed in the preceding section).

2.8 Details of the specific actions that form part of the structural reform program supported by SAL II are set out in the Policy Matrix attached to the Government's Letter of Development Policy (Annex 1). The main elements of the reform program are summarized in Box 2. Further elaboration of the reform program is provided in Sections B-D that follow, linking the SAL II program to the progress made under SAL I. Within the overall program described in the Policy Matrix, a subset of key actions has been identified as conditions for Board presentation and second tranche release. These are set out in Section IV A.

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2 See the President's Report for SAL I (Report No. P-7225-KO, dated March 19, 1998), especially Box 2.

BOX 2: OVERVIEW OF THE SAL II STRUCTURAL REFORM PROGRAM

Building on the progress made under SAL I, the structural reform program supported by SAL II comprises the following main elements:

Financial Sector Reform

- Resolution of weak financial institutions, especially banks, based on agreed timetable and decision criteria on resolution options and supported by diagnostic reviews and assessment of bank rehabilitation plans.
- Adoption and application of agreed principles and processes for the use of public resources in financial sector restructuring and recapitalization and the management of acquired assets.
- Enhancement of the independence, authority and institutional capacity of the agency charged with consolidated supervision of the financial sector—FSC. Strengthening of prudential regulations, especially those relating to connected lending and large exposures.
- Development of the capital market through encouragement of new institutional investors (e.g., mutual funds) and asset securitization, standardization of government bond issues, and strengthening of securities market prudential rules and SROs.

Corporate Sector Reform

- Establishment of a framework for corporate debt workouts led by creditor banks under guidelines established by FSC and linked to financial sector restructuring. The workout process is supported by policies to limit "emergency" loans; reduce cross-guaranties; facilitate debt-equity swaps, asset sales, and M&As; remove tax disincentives; and improve the legal and regulatory enabling environment.
- Strengthening of the responsibilities, independence and accountability of corporate boards, and enhancement of minority shareholder and institutional investor rights.
- Enhancement of creditors' rights through improvements in insolvency laws focusing on expedited procedures (including "pre-packaged" workouts) and in laws on secured lending.
- Adoption by financial institutions and corporations of accounting, auditing and reporting standards consistent with international best practice, introduction of audit committees of boards of directors, and enhancement of the role of independent professional bodies in standard-setting and regulation in accounting and auditing.
- Enhancement of competition through strengthening the Fair Trade Act and its enforcement; ensuring a competitive framework for *chaebol* restructuring; further liberalizing foreign investment; simplifying customs and certification procedures; and removing restrictions on the establishment of holding companies.
- Improvement of the regulatory and institutional framework to support the Government's program of privatization and SOE reform, especially in the infrastructure sectors.

Labor Market and Social Safety Nets

- Improvement of labor market flexibility and efficiency, building on the legalization of layoffs earlier in the year, by reducing restrictions on the use of contract and dispatched workers, strengthening employment services, and eliminating inefficient active labor market programs.
- Extension of unemployment insurance to firms with fewer than 5 workers while adjusting contribution rates to maintain financial viability of the insurance scheme.
- Expansion of the public works program and the provision of means-tested non-contributory income support to the unemployed poor. Allocation of adequate budgets to other targeted poverty programs. Strengthening of information base for improved poverty targeting and monitoring.
- Adjustments to health insurance to improve protection of poor beneficiaries and coverage of major financial risks, and to increase administrative efficiency.
- Reform of pension system including ensuring the adequacy of "social pension" for the elderly poor, and improving transparency and efficiency of pension fund management and strengthening links to capital market development.

B. FINANCIAL SECTOR REFORM

2.9 Financial sector restructuring remains a centerpiece of the structural reform program supported by Bank adjustment lending. Building on the progress made under SAL I, the proposed SAL II would support further actions relating to the restructuring and recapitalization of the banking system, which is now reaching a critical stage as the Government reviews and decides on the rehabilitation and implementation plans submitted by the undercapitalized banks, which include several large banks. As a major source of banks' problems is the overindebtedness of the corporate sector, especially the *chaebol*, a durable rehabilitation of the banking system cannot be achieved without a restructuring of the massive corporate debt and reduction of corporate leverage. It is also clear that while the recent economic shocks have precipitated the crisis in the financial sector, systemic weaknesses had been developing for some time. Accordingly, while the resolution of troubled banks is an immediate priority, the reform agenda includes measures to strengthen bank prudential regulation and supervision, increase competition and improve governance in order to ensure sound development of the financial system in the future.

2.10 The current challenge facing the Government is therefore enormous, as it must promote the simultaneous restructuring of the financial and corporate sectors and improve the regulatory and supervisory regime. At the same time, the Government must pursue the development of the capital market, which will need to play an important role in the restructuring of corporate debt and fostering a less debt-intensive and more diversified corporate financial structure.

Resolution of Weak Financial Institutions

2.11 **Overall Strategy.** The Government has been developing, in consultation with the Bank, an overall financial sector restructuring strategy. The basic objectives and elements of this strategy are outlined in Box 3. The strategy takes an integrated view of financial sector problems, including the restructuring of banks and NBFIs, the related restructuring of corporate debt, and capital market development. To ensure coordination and high-level attention, the Government has charged a four-member subgroup of the President's economic council with dealing with the financial sector crisis and developing the overall strategy. Most of the detailed strategic and operational work has been done by a special structural reform planning unit within the Financial Supervisory Commission (FSC). The unit is in charge of developing the operational strategy and ensuring an adequate institutional infrastructure for implementation.

2.12 **Bank Restructuring and Recapitalization.** Since SAL I, the Government has made significant progress in restructuring the Korean banking system. Twelve commercial banks (there were 26 private commercial banks in all prior to the crisis) that failed to meet the 8 percent capital adequacy standard at end-1997 were asked to submit rehabilitation plans and subjected to asset quality diagnostic reviews prepared by the local offices of internationally recognized accounting firms (with international expert participation). In accordance with evaluation criteria designed with help from the Bank, these plans were evaluated by a Bank Appraisal Committee comprising private sector experts. Based on this evaluation, the FSC announced on June 28, 1998 that the rehabilitation plans of 5 of the 12 banks had been deemed infeasible. These five banks had their business licenses suspended. These banks have since been acquired by five stronger banks under purchase and assumption (P&A) transactions. The Government has committed to provide adequate public support to ensure that the acquiring banks are not weakened as a result of the acquisitions.

BOX 3: FINANCIAL SECTOR OBJECTIVES AND STRATEGY

- *Restore confidence of depositors, creditors and investors:* adoption of a comprehensive and credible overall strategy, and demonstration of progress in implementing the strategy on schedule.
- *Restore solvency, profitability, and liquidity of the financial system (especially banks), and build institutional capacity:* resolution of problem banks (including closures where appropriate) proceeding, based on agreed timetable and supported by diagnostic reviews and assessment of bank rehabilitation plans; significant fiscal resources allocated in support of approved bank restructuring and recapitalization plans; technical assistance acquired; rules relating to foreign ownership in financial institutions and M&As liberalized.
- *Restore solvency, profitability and liquidity of firms*: framework for simultaneous restructuring of the debt of large corporations put in place, led by major creditor banks and overseen by FSC; measures taken to maintain SME access to trade financing.
- *Strengthen financial sector structure and regulatory framework:* under way through adoption of key elements of Basle Committee's Core Principles for Effective Bank Supervision, and other efforts to correct long-standing structural weaknesses; regulations relating to connected lending and large exposures being tightened; financial sector supervision being strengthened and consolidated under one agency—FSC.
- *Adequately and efficiently finance the losses:* principles for use of public funds in financial sector restructuring and recapitalization agreed; need to commit additional public funds agreed.
- *Develop the capital market*: foreign participation in equity and bond markets liberalized; regulatory and institutional framework for these markets being strengthened; mutual funds and other institutional investors important for corporate debt restructuring being encouraged; Government to use the opportunity of large bond issues for financial sector restructuring to develop a more liquid bond market.

2.13 The remaining seven of the undercapitalized banks received conditional approval. These include four large banks that account for more than one third of total commercial bank assets (Cho Hung, Commercial, Hanil, and Korea Exchange banks). All seven banks were instructed to submit revised implementation plans by end-July containing proposed management changes, cost reductions, capital increases, and measures to limit the accumulation of non-performing assets. With Bank support, the FSC requested additional information from these banks in the context of their plans, and provided for further in-depth analysis utilizing foreign experts. The Government has agreed with the Bank on the objectives and principles to be used in making decisions on the implementation plans of these banks, including the provision of government financial support (see Annex 1, pages 12-13). For banks which are subject to direct recapitalization by the Government, the Government would assume the responsibilities of ownership, including contracting with experienced senior managers to undertake necessary restructuring, until sale to strategic investors with sufficient capital and expertise to manage banks.

2.14 Decisions on the implementation plans of these banks, supported by domestic and international experts, were announced at the end of September. Two of the large banks (Commercial and Hanil) will merge, and the Government will provide substantial financial support and take up 95 percent ownership interest in the combined bank. The two other large banks (Cho Hung and Korea Exchange) are currently negotiating a merger, which, if approved, would also require substantial government financial support. Of the remaining three banks not meeting the capital requirements, Kangwon Bank likely will merge with a merchant bank and receive financial support from the Government. The two other small banks will continue to be monitored for progress on implementation plans including recapitalization. Progress on rehabilitation measures will determine future government actions.

2.15 Banks whose implementation plans are approved will enter into a Memorandum of Understanding with the FSC covering, inter alia, recapitalization and merger plans, measures to manage and reduce non-performing assets, and timetable for achieving agreed performance indicators (including capital adequacy targets).[3] The approval of a bank's implementation plan will require a significant and immediate initial increase in capital. Banks whose approved plans are not in the event achieved would be taken over by the Government.

2.16 Diagnostic reviews of the remaining 12 commercial banks are under way and will be completed by September 30. The FSC has been receiving technical input from a team of Bank staff and consultants to support the integrity of this process. If, on the basis of the diagnostic reviews and revised asset classification and provisioning rules, a bank's BIS-based capital ratio is found to be below 8 percent as of end-June 1998, FSC will request the bank to submit a rehabilitation plan and will proceed in a manner similar to that described above for the seven undercapitalized banks.

2.17 The existing shareholders in the two major banks that were intervened last year (Korea First Bank and Seoul Bank) have been written down below a 10% ownership stake. The Government has initiated the privatization of these banks, with the objective of attracting foreign capital and expertise into the system. The preparation for privatization, supported by an investment bank, is well under way. Bids are to be obtained by November 15, with completion of the transactions planned by March 31. The Government is expected to enter into a binding commitment to sell majority ownership interest in at least one of the banks to the highest qualified bidder by end-December 1998.

2.18 **Restructuring of Non-Bank Financial Institutions.** The merchant banking sector has been substantially consolidated. The 14 merchant banks that have been allowed to continue to operate (out of a pre-crisis total of 30) are subject to a program of intensive supervision, including in-depth diagnostic reviews where warranted to update assessment of financial condition, determine capital ratio integrity, and assess compliance with previously approved rehabilitation plans. All of the 14 banks met a capital asset ratio of 6 percent at end-June. The operating procedures of the Bridge Bank managing the assets of the closed merchant banks have been clarified.

2.19 Diagnostic reviews have been initiated for specialized and development banks. Progress is also being made in restructuring and rehabilitating other NBFIs that, like banks, have been seriously affected by the crisis. In general, however, the restructuring process in the case of the NBFIs is at a relatively early stage. Some such institutions (including investment trust companies, securities brokerage houses, and insurance companies) have had their licenses revoked. All securities firms, insurance companies, leasing companies, and investment trust companies have been asked to submit rehabilitation plans, followed by review by the FSC and, if necessary, resolution through closure. The timetable for these actions differs across types of institutions, but submission of rehabilitation plans is generally set for September-October, with the first round of restructuring expected to follow thereafter.

2.20 **Use of Public Resources.** The restructuring and recapitalization of the financial system is expected to be costly. The Government has so far provided for public support of up to W75 trillion (about

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[3] The performance indicators would include improvements in capital ratios to 6 percent by March 1999 and 8 percent by March 2000 (banks would be encouraged to increase their capital ratios further to 10 percent by December 2000). For regional or small banks, the targets for capital ratios would be 4 percent by March 1999, 6 percent by March 2000, and 8 percent by December 2000.

17 percent of GDP), to be financed mainly from bond issues, but the eventual commitment of public resources is likely to be higher. The financial system's non-performing loans have continued to increase. Such loans were estimated at W144 trillion at end-June, of which W110 trillion were for banks (close to 20 percent of banks' total loans).[4] Adequate commitment of public resources will be essential to support a proactive and effective strategy for financial system restructuring and recapitalization.

2.21 Given the prospective high cost, it is all the more important that public funds be used as cost-effectively as possible. The Government has adopted a set of principles to guide the use of public resources in financial sector restructuring and recapitalization. Any use of public resources to support financial institutions will be preceded by rigorous analysis of those institutions and will be conditioned upon those institutions undertaking substantial operational and financial restructuring. The Government has agreed that public funds will be used only in the context of FSC-approved rehabilitation and implementation plans, government takeover of undercapitalized banks, or bank liquidation. Adequate burden-sharing will be assured either through the write down of existing shareholder capital, in the case of direct recapitalization by government, or through contribution of new capital by existing or new shareholders in the case of approved private sector recapitalizations and mergers. The provision of public support will also be conditioned on adequate progress by banks in implementing sound corporate restructuring, which will be monitored by FSC (the framework for corporate debt restructuring is detailed in a later section). Moreover, any private sector acquisition of equity positions in government recapitalized banks will be through a transparent process and, as much as possible, open bidding. In the context of NBFI resolutions, only explicitly government-guaranteed liabilities will be covered. In exceptional cases, and in the context of a comprehensive restructuring plan, support may be provided to NBFIs if failure of these institutions poses a systemic risk. Under SAL I, the Government agreed to record all public support for financial sector restructuring on a transparent basis.

2.22 Further policy decisions have been made regarding the role of the Korea Asset Management Corporation (KAMCO) in the purchase of non-performing loans. Purchases by KAMCO will be at prices that reflect actual and expected recovery rates as well as the opportunity cost of the funds employed for collateralized loans, and nominal prices for unsecured loans. The disposition of the troubled assets acquired by KAMCO will be subject to principles and modalities developed in consultation with the Bank, including the disposition of a majority of such assets within three years of acquisition. Disclosure of KAMCO's activities will be enhanced through the publication of semi-annual and annual audited financial statements (including results of reviews of asset portfolio revaluations). The ongoing program for building KAMCO's institutional capacity, supported by technical assistance, will be strengthened, to include improved design and implementation of organizational and operational structures and asset inventory and management information systems. It has also been agreed that capital injections into banks from the Korea Deposit Insurance Corporation (KDIC) will be on terms that provide the Government with a share in any improvement in profitability and give the Government powers to take control, e.g., by the exercise of conversion rights, in the event of a deterioration.

[4] Of the W110 trillion, W50 trillion is estimated as more than three months overdue and the rest are classified as precautionary (likely to become non-performing).

Strengthening Supervision and Regulation

2.23 **Strengthening the FSC.** The basis for a new financial supervisory system was laid with the establishment of FSC in April 1998 as an integrated financial supervision body. Under the new system, all financial institutions (banks, securities, insurance and other NBFIs) will be supervised by the FSC and its executing body, the Financial Supervisory Board (FSB). The reform schedule calls for all four existing supervisory agencies (Banking Supervisory Authority, Securities Supervision Board, Insurance Supervisory Board, and the Non-Bank Financial Institution Supervisory Authority) to be fully integrated into the FSB by end-1998. The Government recognizes that independence and freedom to act without political interference are essential for a supervisory agency to effectively perform its role of ensuring the soundness of the financial system. While increased independence had been provided through the legislation establishing the FSC, the Government will take additional steps to enhance FSC's independence and authority, consistent with the Basle Committee's Core Principles for Effective Banking Supervision. This includes ensuring operational independence and adequate funding. A legal framework will be established through which FSB may assess fees on supervised institutions, with revenues dedicated to the operations of FSB. The issuance and revocation of financial institutions' licenses will henceforth be carried out upon the recommendation of FSC. The governance structure of the FSC will be reviewed to enhance its independence and effectiveness, including through increased representation of individuals nominated by independent professional associations.

2.24 With the consolidation of supervisory organizations, supervisory arrangements for commercial banks will be extended to all NBFIs. The FSC will also be authorized to conduct examinations and recommend supervisory actions against specialized and development banks, and prudential rules applied to commercial banks will be extended to these banks taking into account their specific characteristics. Effective performance of enhanced, consolidated supervision will require institutional strengthening of FSC. A strategic blueprint for FSC's institutional strengthening has been prepared. Supported by technical assistance, qualified consulting firms will be employed to assist in its implementation.

2.25 **Upgrading Regulation.** Since SAL I, the Government has strengthened the regulatory framework to conform more closely to international norms. Changes have been made in the following dimensions: mark-to-market accounting, disclosure of non-performing loans, asset classification criteria, and foreign exchange liquidity and exposure criteria. On July 1, 1998, additional prudential regulations and reporting requirements were announced covering: loan classification and provisioning, accounting and disclosure of trust accounts, and short-term foreign borrowing and foreign exchange exposures. Limits on connected lending that apply to commercial banks (25 percent of equity capital) will be extended to merchant banks, and full disclosure will be required of such lending. To reduce large exposures, single borrower and group exposure limits for commercial banks, redefined to include all off-balance sheet exposures, will be reduced from 45 to 25 percent of total capital as of end-June 2000 (from 100 to 25 percent in the case of merchant banks), with a phased reduction of exposures in excess of these limits. The aggregate of exposures in excess of 10 percent of total capital will be limited to 500 percent. The Financial Restructuring Act has been amended, inter alia, to redefine a "distressed" financial institution so as to allow imposition of sanctions before actual insolvency is reached and the full write down of shareholder equity. To facilitate corporate debt restructuring, the FSC will issue further guidelines on the treatment of restructured debt and workout processes and asset management in banks.

2.26 Deposit insurance has been improved through its consolidation in one agency (KDIC). The Government has initiated a narrowing of the present general protection. All deposits made until July 31, 1998 are fully protected until the year 2000. Under a revised deposit protection law, for deposits made after August 1, 1998, only the principal will be guaranteed until 2000 if the amount exceeds W20 million (both principal and interest will be guaranteed for smaller deposits).

Capital Market Development

2.27 The Government is keen on developing the capital market to support the restructuring of corporate finances away from debt and also reduce the burden of corporate financing and associated risk thus far carried by the banking system. Most restrictions on foreign investment in listed securities have now been removed. The ceiling on foreign ownership of listed stocks, 26 percent pre-crisis, has been eliminated altogether. Both ERL and SAL I supported this major liberalization. Foreign equity investment in non-listed companies is also now allowed. Under SAL I, task forces were established to review the functioning of the bond and equity markets and several steps taken to improve the regulatory framework for these markets. Building on the progress made, and based on recommendations of the task forces, SAL II will support further actions to expand and deepen the bond and equity markets.

2.28 While Korea's organized trading markets have attained respectable operational sophistication, the highly concentrated market structure and the resulting lack of competition have led to a high cost structure. Heavy regulatory control and lack of exposure to external competition have inhibited commercial sensitivity on the part of the Korea Stock Exchange (KSE) and other market agencies, while the ownership structure of the clearing and settlement institution (KSD) has hampered its service. To promote greater inter-market competition, a new regulatory framework is necessary, providing greater independence to market institutions (e.g., KSE, KSDA, KITCA). The SAL II program will therefore support the reform of the governance structure of these agencies. Korea's securities industry has attained the maturity where enhanced self-regulation, with appropriate oversight, will bring greater trust to investors, lead to more self-discipline, and promote more spontaneous growth. The program proposes that FSC delegate to the securities market agencies increased authority to regulate and supervise their members (with FSC retaining adequate regulatory and supervisory power over these agencies themselves). It also calls for strengthening prudential rules for securities market activities—standards for risk management, adoption of mark-to-market accounting, use of credit rating. Improvements in financial disclosure and minority shareholder rights, discussed later in the section on corporate governance, will also support securities market development by enhancing investor confidence.

2.29 Progress is being made in developing a more liquid and active bond market. Treasury auctions have become more market-based and fuller information is provided to the market. The Government is putting in place the institutional setup to develop a clear, comprehensive new funding strategy, covering a rolling three-year period and including financing of the costs associated with financial sector restructuring. Within this framework, the development of the government bond market, which serves as a benchmark for the private bond market, will be pursued through a standardization of new securities issued by government and government agencies, consolidation of existing instruments, and phasing out of the issuance of government-guaranteed KAMCO and KDIC bonds in favor of direct issuance by government. The creation of a market-makers' network, producing more liquid secondary markets, will be supported by adopting clear rules for the selection of primary dealers in government bonds and authorizing banks to act as market makers. To help implement this agenda, the Treasury Division of the Ministry of Finance will be institutionally strengthened, supported by technical assistance.

2.30 The development of the domestic bond market needs to be an integral element of public asset-liability management (ALM). Supported by SAL I, the Government has established an external debt management office, and the development of an ALM system for external debt is underway. Under SAL II, and supported by technical assistance, this will be expanded into an overall ALM framework, incorporating domestic public debt and contingent liabilities. Such an integrated public ALM framework would permit better coordination between government borrowing strategy, risk management, and the development of domestic bond market.

2.31 Institutional investors will need to play an important role in the restructuring of corporate debt. SAL II will support the strengthening of the institutional investor base through changes in the legal and regulatory framework allowing the establishment of mutual funds and other corporate restructuring vehicles (see also para. 2.43). Improvements in the management of pension system reserves conducive to capital market development are underway (see section on pension reform). Financial and corporate sector restructuring will be facilitated also by legislation allowing the issuance of asset-backed securities. To facilitate asset sales, legal restrictions on foreign ownership of land and real estate properties have been removed.

C. CORPORATE SECTOR REFORM

2.32 A key priority is to accelerate the process of corporate debt restructuring. Corporate debt is estimated on the order of $500 billion (about 150 percent of GDP), 90 percent of which is domestic, and for large corporations amounts on average to as high as five times their equity. This heavy debt burden, a substantial and increasing part of which is now of a problem status, is a major reason for the current deep and widespread distress in the corporate sector. Lowering this high corporate leverage is essential to corporate revival and reducing corporate vulnerability to future shocks. As noted in the preceding section, restructuring corporate debt is also essential to successful financial sector restructuring.

2.33 To restore, and maintain, viability and competitiveness, Korean firms need both financial and real restructuring. The latter requires improvements in the governance of firms and increased exposure to competitive pressures. Accordingly, the corporate sector reform agenda of SAL II comprises both corporate debt restructuring and improvements in corporate governance and competition policies, building on actions taken under SAL I. It also includes the privatization and reform of state corporations, especially the promotion of competition and private entry in the monopolized infrastructure sectors.

Corporate Financial Restructuring

2.34 Excessive corporate indebtedness amongst the major corporate groups known as *chaebol* has been an important factor contributing to the current economic crisis in Korea. Over the last several decades, these major groups have expanded via a very aggressive use of leveraging, borrowing from Korean commercial and merchant banks, often short term, to finance fixed or long-term investments. Although most of the major subsidiaries of the largest groups are publicly listed, the Korean stock market is thinly capitalized, especially when compared to other economies that are comparable to Korea's, and the groups have traditionally raised little in new equity. The Government supported this expansion and often directed the *chaebol* into specific lines of business. Government licensing was the mechanism used to control entry into a new sector. Borrowing was assured if the groups adhered to government guidance. Banks allocated credit to the large corporations relying on real collateral and a very complex system of cross guarantees from affiliates within the group, as well as personal guarantees from group executives. Relatively little attention was paid to the earnings performance and cash flow generation of their borrowers, that is their ability to repay. The five largest *chaebol* absorbed about 40 percent of all credits provided by commercial banks.

2.35 This policy of aggressive leveraged expansion worked well as long as the economy expanded vigorously and returns on new investments exceeded their cost of capital. In recent years, however, all measures of group financial performance among the 30 largest *chaebol* have worsened—free cash flow, return on equity, profit margin, return on assets, debt coverage ratio—while their debt/equity ratios have continued to rise. The debt/equity ratio of these groups far exceeded prudent levels and by end-1997 had reached an average of over 500 percent (600 percent if the debt of their financial subsidiaries is included).

2.36 With the onset of the economic crisis in 1997 and the spike in interest rates, five major groups with about $20 billion in assets quickly failed, unable to pay their debts. At least five additional large groups have petitioned for bankruptcy since then. Moreover, it soon became apparent that 18 of the largest 30 groups were at risk of bankruptcy, with combined liabilities of about $75 billion. Not surprisingly, a series of syndicated emergency loans were provided by major banks to a number of major groups at risk, totaling some W2.5 trillion.

2.37 The problems of the largest groups quickly spread to small and medium enterprises (SMEs). Many of these SMEs operate as satellites of the major groups, dependent on them for business. Also, a complex system of payments from the big to small firms via promissory notes, traditionally discounted at banks, adversely affected the liquidity of the latter as the terms of the notes were extended from an average of 30-60 days to 90-180 days and discounting rates rose from 12 to 25-30 percent, if in fact the banks would discount the notes at all. Moreover, SMEs that exported found it very difficult to finance imports of needed raw material. A large number of SMEs have gone bankrupt. The Government has taken steps to assist SMEs (para. 1.7), but their recovery will also hinge importantly on the resolution of the problems of the larger firms.

2.38 There is an urgent need for corporate restructuring, especially among Korea's major groups or *chaebol*. As the highest priority, the chaebol need to restructure their balance sheets, increasing their equity and improving the maturity profile of their debt. Also, a longer-term process of real restructuring needs to occur, including improved corporate governance, product line rationalization, increases in productivity, and a fundamental change in corporate strategies and culture which focuses on profitability and liquidity versus aggressive expansion at virtually any cost. The first step is financial restructuring, which is necessary for the recovery of the financially distressed but viable corporations. Reducing debt/equity ratios is essential also to the future financial health of Korea's corporations, as continued high leverage would mean continued vulnerability to future financial shocks. The restructuring of corporate finances is closely related to banking sector restructuring and recapitalization. Without resolving the problem corporate loans and reducing corporate leverage, a durable resolution of the banking system problems will be difficult to achieve and bank recapitalization will likely need to be repeated.

2.39 The Government's strategy for corporate financial restructuring comprises four, related elements:

(a) improving the enabling environment—changes in the legal, regulatory and institutional framework that facilitate debt restructuring and reduction of leverage;

(b) supporting the restructuring and recapitalization of creditor banks;

(c) developing the capital market; and

(d) establishing a framework for workouts of corporate debt.[5]

2.40 The first three elements of this strategy have already been under implementation. (a) Supported by SAL I, significant actions have been taken to improve the enabling environment for corporate restructuring, including liberalization of foreign investment in stocks and bonds, clarification and liberalization of rules for M&As including permitting foreign investors to undertake hostile takeovers, granting of tax incentives, e.g., on asset sales, liberalization of the real estate market to foreigners, improvements in financial disclosure and reporting, improvements in insolvency procedures, and facilitation of labor redeployment through legalization of worker layoffs and improvements in unemployment insurance. (b) The process of bank restructuring and recapitalization is well under way, which will support banks' efforts to work out claims on their corporate clients. The strengthening of banks' capital and management is essential to the success of the bank-led corporate debt restructuring framework that has been put in place (see below). The provision of public support for bank recapitalization will be related, among other criteria, to progress banks are making in restructuring corporate debt. To facilitate debt-equity swaps, the ceiling on banks' ownership of other firms' equity has been raised. New, clearer guidelines have been issued on prudential and tax treatment of restructured corporate debt. Prudential regulations relating to connected lending and large exposures are being tightened. (c) The magnitude of corporate overindebtedness is such that the problem cannot be resolved through debt restructuring and equity swaps with banks alone. The capital market, especially the equity market, must be mobilized aggressively. SAL I supported several measures to develop the equity and bond markets. Additional measures, such as legal changes facilitating the establishment of mutual and venture capital funds and issuance of asset-backed securities, form part of the SAL II program.

2.41 Details of measures under items (a) to (c) above are provided in respective sections elsewhere in this report. This section focuses on item (d), measures that deal more directly with the problem of corporate overindebtedness by facilitating debt workouts between the corporations and their creditors. Supported by the proposed SAL II, and the complementary technical assistance loan (FCRAL), a framework for such workouts has been established and its main elements are described below.

2.42 **Framework for Debt Workouts.** The FSC has been charged with the responsibility to develop and oversee a framework for corporate workouts, related to financial system restructuring. This framework has now been established and focuses on a program of voluntary workouts between banks and non-bank financial institutions and major corporations utilizing the "London Rules." The London Rules basically call for extra-judicial resolution of problem debtors. A Corporate Restructuring Agreement (CRA) has been signed by some 200 Korean banks and non-bank financial institutions which commits them to follow agreed workout procedures. Eight major creditor banks identified as Lead Banks will take the responsibility for negotiating workouts with the 64 major corporate groups. Each of the banks has formed a Workout Unit which will be supported by external financial advisors, financed by the Bank's technical assistance loan (FCRAL). In the event the financial institutions cannot agree on a workout strategy among themselves or the Lead Bank and the debtor cannot reach agreement, an arbitration committee, the Corporate Restructuring Coordination Committee, has been created to resolve such differences. If a CRA signatory fails to comply with an approved workout agreement or CRCC arbitration decision, the CRCC has the

[5] Also relevant, in addition to these elements, is of course macroeconomic management that would permit a further lowering of interest rates and a recovery of domestic demand consistent with preservation of external financial stability, thereby favorably affecting corporate finances.

power to impose penalties. The FSC will monitor the workouts agreed under the CRA to ensure consistency with the guidelines issued for the workouts.

2.43 **Supportive Policies.** The Government has agreed to undertake a series of policy measures to support the debt restructuring process. These include the following:

(a) *Curtailing "Emergency" or "Rescue" Loans.* The Government has agreed not to direct banks to make emergency syndicated loans to troubled debtors in the future (which had the effect of delaying the needed debt restructuring). It has agreed that fresh capital would be provided to financially distressed but viable corporations normally only in the context of the workout process, and subject to guidelines that limit the amount, require debtors to allow complete creditor access to their records, and require a financial assessment by the Lead Bank's advisors of the debtor's financial viability. In exceptional cases, corporations not in the process of a workout, but due to be restructured, may be provided new loans, if the banks are willing, but subject to the same guidelines, and for a maximum period of six months which should provide sufficient time to establish a CRA workout. The incentive for corporations to restructure is the promise of fresh capital, and the penalty of a cut-off of new financing for failure to restructure.

(b) *Facilitating Debt/Equity Conversions.* The stock of corporate debt is so large that sustainable debt/equity ratios cannot be achieved over a reasonable time frame only through the flow of new equity, asset sales and retirement of debt. In addition to such flows, stock adjustments in the form of conversion of debt into equity will be necessary. The Government will remove regulatory and tax disincentives to debt/equity conversions so that this instrument can be fully utilized in the corporate workout process. Because banks can hold only so much corporate equity, and may be ill-prepared to manage converted equity, corporate restructuring vehicles (CRVs) will need to play an important role in purchasing and/or managing converted equity. The CRVs, e.g., trusts or mutual funds, might operate by purchasing converted equity from the banks, managing converted equity for a fee, or purchasing debt and converting it into equity. The CRVs would be privately owned and managed. The Government has undertaken to review the tax and regulatory regime to remove any barriers that may exist to the establishment and operation of such vehicles.

(c) *Reducing Cross Guarantees.* The *chaebol* have generally supplied guarantees to their affiliates and subsidiaries to secure loans. This has created a very complex pattern of cross-linked guarantees which is difficult to isolate and unwind. Cross guaranties allow loss-making affiliates to continue to borrow from banks and drain financial resources from healthier affiliates. They, therefore, both postpone reckoning for non-viable affiliates and compromise the financial health of the whole group. Under a law passed in April, the Government prohibited new cross guarantees and required that all existing guarantees be unwound by April 2000. The FSC is encouraging banks to reduce cross guarantees through the workout process, and is proposing market-based approaches to unwind these guarantees, such as exchanging the guarantees for equity or warrants. The FSC has required financial institutions to report on the stock of guarantees as of end-June, 1998, and to submit quarterly progress reports on reducing these guaranties. The FSC will also establish benchmarks for monitoring this progress.

(d) *Other Policy Measures*. The Government will submit to the National Assembly tax measures to encourage corporate M&As, debt restructuring and asset sales. It will also propose changes to insolvency procedures to expedite court-supervised insolvency (details in the section on legal framework for creditors' rights). The Korea Fair Trade Commission (KFTC) will step up its investigation and monitoring of illegal intra-*chaebol* financial transfers to weaker affiliates. Recently, the KFTC imposed stiff fines on the major *chaebol* found to have engaged in such transfers.

2.44 **Implementation Process.** An accelerated implementation of corporate restructuring will be supported through several measures. (i) A special task force of four Lead Banks will focus attention on the top five *chaebol*. It will monitor their capital structure improvement plans, submitted under guidelines provided by the FSC, and identify affiliates to be restructured or liquidated. The banks have recently submitted to the FSC a list of about 25 subsidiaries of the top five *chaebol* that they have identified as candidates for liquidation. (ii) Of the *chaebol* ranked 6-64 in size, the FSC has asked banks to identify 16 initially and proceed with inter-creditor agreements leading to CRA workouts. (iii) The FSC has directed banks to halt and withdraw financing in the case of the 55 companies that were declared non-viable in June, and to provide monthly reports on progress in exiting these companies and on additional companies identified to be non-viable. (iv) The FSC has directed the Lead Banks to send auditors into *chaebol* affiliates that have received emergency loans to assess their financial position and recommend action within two months. Not surprisingly, companies that have received emergency loans figure prominently in the first 16 *chaebol* to be restructured. (v) The FSC has required Lead Banks and the CRCC to submit monthly reports on the status of corporate workouts. (vi) The resolution of firms under court supervision where the Government is a major shareholder is being expedited (Kia Motors, Hanbo Steel). (vii) A "situation room" has been created within FSC to monitor the financial performance of *chaebol* and provide early detection of insolvency or default.

Corporate Governance

2.45 The economic crisis in Korea is partly a consequence of the failure of corporate governance. The normal disciplines capable of containing risky corporate behavior—close monitoring by boards of directors and shareholders, effective regulation based on reliable information, and the threat of bankruptcy—had been largely absent.

2.46 **Corporate Boards and Shareholder Rights.** Directors and minority shareholders need to play a more active role as monitors of corporate performance. In the past, boards of directors of large companies were dominated by insiders, had diffuse responsibility, and tended to be passive supporters of the wishes of controlling shareholders. As Korea seeks to restructure and modernize its corporate sector, a fundamental change will be needed in the role of corporate boards in order to improve their effectiveness and accountability to shareholders. SAL I required that outside directors be included on the boards of all listed companies and banks, and under SAL II their representation on the boards has been increased to a minimum of 25 percent. Changes will be made in the Commercial Code to impose on directors and "shadow" directors clear responsibilities to the company and shareholders.

2.47 Minority shareholder rights have been strengthened. Under SAL I, the threshold for the exercise of such rights, e.g., the right to convene a shareholders' meeting and to make proposals at a meeting and inspect company records, had been lowered. These thresholds will be lowered further under SAL II. Minority shareholders will be given a greater say in the election of directors and in the conduct of company business. Steps will be taken toward allowing class action law suits by shareholders of listed companies. Also, restrictions on the voting rights of institutional investors will be removed.

2.48 **Legal Framework for Creditors' Rights.** A consequence of the prospective corporate restructuring will be a sharp increase in filings under the insolvency laws. While the laws are basically sound, and were improved under SAL I, further improvements are desirable in view of the extraordinary demands likely to be placed on the insolvency system. The reorganization option is rarely used, as it results in the immediate displacement of the existing management. As a result, debtors have little incentive to file at an early stage of liquidity difficulties when viable restructuring may be feasible. The process is also complex and requires intensive court involvement. Further streamlining and simplification of procedures will assist the courts to deal effectively with their increased workload. In particular, laws need to be changed to encourage informal workout agreements between debtors and creditors. While informal workouts can be conducted entirely outside the court system, there is no moratorium protection available in those circumstances beyond a voluntary moratorium agreed between specific creditors and a debtor. The reorganization option is not well suited to a pre-negotiated workout while the composition option is unavailable to larger firms. One possible reform is the "pre-packaged" bankruptcy plan that can be readily approved by the court based on standards as to the adequacy of financial disclosure to creditors during the workout negotiations. Under SAL II, legislation will be introduced to make further improvements in the insolvency laws along these lines, including changes to facilitate "pre-packaged" workouts.

2.49 The insolvency (bankruptcy, reorganization or composition) proceedings are dealt with at the District Court level, with limited rights of appeal to the Supreme Court. While some District Court judges have become relatively skilled in handling these cases, there are only a few judges assigned predominantly to insolvency work. This suggests the need to establish specialist courts to handle the expected upturn in insolvency filings. SAL II envisages the establishment of a pilot specialist bankruptcy court in Seoul with dedicated judges.

2.50 As reforms of the financial system proceed, it will be important to consider complementary reforms to expand the range of available lending instruments. Small and medium-size enterprises are especially vulnerable to ongoing changes in the traditional credit market. While the promissory note system has been the mainstay of SME financing of working capital needs, the collapse of the merchant banking sector has largely eliminated this source of funds. Since SMEs are unlikely to have significant real estate or other fixed assets available to be collateralized, they must rely on inventory and book debts as security for their lenders. Korean law does not permit a modern system of secured lending on inventory and book debts to develop. The law recognizes only simple forms of security based either on pledge or the transfer of title of specified assets to the creditor. There is no means of giving security over a revolving pool of assets such as inventory or book debts. And there is no national registry system that would allow lenders to identify whether assets are available to be charged. The Government will accordingly prepare legal and institutional changes necessary to facilitate secured lending on movables.

2.51 **Financial Transparency and Accountability.** The program provides for far-reaching reforms in accounting, auditing and reporting that should contribute greatly to enhancing financial transparency and accountability and instilling increased market confidence in the integrity of financial reporting and disclosure. The reform agenda, initiated under SAL I, comprises the following main elements: rationalizing the institutional framework for standard-setting, regulation and oversight in accounting and auditing; upgrading accounting and auditing standards to international best practice; increasing financial oversight by boards of directors and strengthening the internal audit function; and improving the quality and frequency of financial reporting.

2.52 Actions to rationalize the institutional framework for accounting and auditing will include: consolidating appropriate government regulatory authority in one agency—the Securities Supervisory Board; enhancing the role of an independent and self-regulating professional body (KICPA) in the regulation and monitoring of the profession and issuance of auditing standards; and setting up an independent accounting standard setting organization. To give effect to this reform, a time-bound implementation plan will be adopted to amend applicable laws and regulations, remove barriers to competition in the profession, and institutionally strengthen the KICPA.

2.53 Under SAL I, the Government announced that financial statements of listed companies, banks and other financial institutions, as well as joint stock companies with assets in excess of W7 billion will be prepared and audited in accordance with standards consistent with international best practice beginning in 1999. The new and improved accounting standards, consistent with international best practice and prepared with participation of representatives of internationally recognized accounting firms, will be issued by December, covering inter alia: asset classification, loss and income recognition, troubled debt restructuring, financial statement disclosure, combined financial statements, financial instruments, leases, revaluation of assets, and translation of foreign currencies. Revised auditing standards will also be issued.

2.54 Financial oversight of management performance has been weak. Boards of directors need to play a more active role in enhancing the integrity of the financial reporting process, overseeing the operation of internal control, and ensuring a comprehensive and unbiased audit by an independent auditor. To strengthen the independence and effectiveness of internal and external audit, a study was initiated under SAL I on the introduction of audit committees of boards of directors in listed companies. As the next step, SAL II envisages the adoption of a time-bound implementation plan for the establishment of such committees consistent with international best practice. In the interim, it calls for improvements in the existing audit selection committees to make them more independent and transparent.

2.55 Alongside improved quality, increased frequency of financial reporting will allow investors, creditors and regulators to better monitor firms' performance. Listed companies have been required to publish half-yearly audited financial statements. Beginning with the first quarter of the year 2000, listed companies will be required also to publish quarterly financial statements. For commercial banks, this requirement will come into effect in the third quarter of 1999.

2.56 The Bank is also supporting efforts to promote transparency and good governance by limiting the scope for corruption. An IDF grant will support a streamlining of regulations and procedures to reduce the opportunities for corruption that arise from excessive regulation. It will also support a rationalization and strengthening of institutions concerned with the prevention of corruption, and enhancement of the code of conduct for civil servants.

Competition Policies

2.57 Shielded from adequate exposure to competition in the past, the Korean industrial sector is highly concentrated and has seen its productivity performance and competitiveness decline. Korea first enacted the Fair Trade Act (FTA) in 1981 but it has generally been ineffective in enhancing domestic competition. The Government controlled many aspects of the economy and directed it through measures such as price controls, credit rationing, barriers to foreign investment and other policies limiting competition. These distortions played a role in firms making risky investment decisions and becoming sluggish in their response to changing global market conditions. Only relatively recently has Korea taken steps to lower trade and investment barriers and to enhance the powers of the Korean Fair Trade Commission (KFTC) to limit anti-competitive practices.

2.58 SAL I included a set of measures to strengthen competition policies. While progress has been made in implementing that program, especially in liberalizing the foreign investment regime, implementation of some other measures—those relating to the strengthening of the FTA and KFTC—has been slower than envisaged. SAL II aims to accelerate and deepen reforms to enhance competition.

2.59 **Strengthening the Fair Trade Act.** Central to the enhancement of domestic competition is the strengthening of the FTA and its transparent and effective application. As provided for under SAL I, the Government has completed a detailed review of the FTA through a Joint Public/Private Sector Committee to formulate amendments to the FTA and identify measures which would strengthen the FTA's market efficiency objectives, make its provisions fully and uniformly applicable to all economic sectors, including public entities, and increase the KFTC's investigative and sanctions powers. Delay in the completion of the review put back the timetable for the enactment of amendments to the FTA that were to be based on the Committee's recommendations. These amendments to the FTA will now be enacted later this year as part of the SAL II program.

2.60 The Government has agreed to strengthen the enforcement of rules limiting non-arms length transactions between related corporations, companies, financial institutions, their owners, directors, shareholders and employees. It has agreed to apply existing laws stringently and uniformly, and to propose amendments to the FTA to further limit such transactions. In addition, the Government has agreed to enact an Act on Comprehensive Regulation of Cartels. It will also review and propose amendments to government procurement guidelines to improve transparency.

2.61 **Providing a Competitive Framework for Corporate Restructuring.** The KFTC is mandated under the FTA to play a major role in the restructuring of the Korean corporate sector. Per SAL I commitments, the Government issued a policy statement announcing various measures to ensure full enforcement of the provisions of the FTA to the restructuring of the *chaebol*. These measures include: prohibiting business combinations which substantially reduce competition in a given market; fostering the entry of new domestic or foreign firms in the divestment of *chaebol* operations; and disseminating information. The KFTC has issued comprehensive M&A guidelines and will closely monitor compliance, especially in *chaebol* restructuring.

2.62 **Allowing the Establishment of Holding Companies.** Legislation will be enacted to remove current restrictions under the FTA on the creation of holding companies to permit such structures subject to conditions to avoid undue ownership concentration. This change will allow the replacement of the present opaque ownership structures of large business groups (the *chaebol*) with a more transparent system, with greater clarity of rights and obligations within groups.

2.63 **Liberalizing Foreign Investment and Trade Regime.** The ceiling on foreign investment in listed stocks, raised from 26 to 55 percent earlier in the year, has now been lifted altogether, ahead of program schedule. This opens the way for 100 percent foreign ownership of listed Korean companies. A new Foreign Investment Promotion Act aimed at encouraging FDI has been enacted which will simplify approval and registration procedures and move toward national treatment of foreign enterprises, establish a one-stop shop, provide tax incentives, facilitate leasing of public property, and allow the establishment of

Foreign Investment Zones. Foreign participation in M&As has been liberalized, including allowing foreign investors to undertake hostile takeovers.

2.64 Cumbersome customs administration and drawn-out product certification/registration have been a major bloc to import competition. They have also been a factor frustrating FDI. The Government has now agreed to review customs clearance and product certification/registration procedures and develop and implement a plan to streamline them.

2.65 **Furthering Industrial Deregulation.** In addition to the foregoing improvements in competition policies that have an impact across industries, attention is being given to removing barriers to entry and other distortions that impede competition within specific sectors or industries. A Deregulation Committee coordinated by the Prime Minister's Office is leading this reform. Several industry studies have been commissioned by this Committee which will form the basis for implementing necessary legislative or regulatory changes.

2.66 **Strengthening the Korean Fair Trade Commission.** Effective implementation of the competition policy agenda will require substantial institutional strengthening of the KFTC. SAL I identified several actions in this regard—the strengthening of policy analysis and evaluation capacity, provision of timely information to the market, enhancement of operational capacity and transparency—on which progress so far has been rather slow but is beginning to pick up. The institutional strengthening effort will be continued under SAL II within an agreed work plan, including the development of detailed operational guidelines. This will be supported by provision of technical assistance through the FCRAL.

Reform and Privatization of State-Owned Enterprises

2.67 The ongoing reform of the corporate sector extends to state corporations. Korea has some 26 "parent" state-owned enterprises (SOEs) with a total of 82 subsidiaries. As part of its broader reform program, and to release resources to facilitate other structural reforms, the Government has initiated a major reform of its SOEs. This reform, that SAL II would support, is based on five main principles: activities that are better performed by the private sector are to be privatized or contracted out; de-monopolization is to be pursued through deregulation and other means; SOEs are to be restructured to redirect their resources to "core" businesses; corporate governance structures are to be revised to give greater autonomy to management while enhancing accountability; and corporate transparency is to be enhanced through publication of performance indices and adoption of internationally accepted accounting principles.

2.68 **SOE Restructuring and Governance Reforms.** SOEs that are to remain under state control or are to be privatized gradually will be subject to comprehensive restructuring to improve efficiency and accountability. At present, Korea's SOEs fall within two categories: "state-capitalized" enterprises (SCEs), in which the Government owns more than 50 percent of the equity and which are subject to the SCE Management Act; and "state-invested" enterprises (SIEs), in which the Government usually owns less than 50 percent of the equity and which are not subject to any special law. SOEs report to relevant sector ministries, which have used enterprises to pursue diverse non-commercial objectives. The Government recognizes the need to reform these arrangements, and will make necessary changes to the SCE Management Act.

2.69 **General Privatization Program.** In July, the Government announced its privatization plans for one SCE (Korea Electric Power) and ten SIEs (Korea Telecom, Korea Tobacco and Ginseng, Pohang Iron and Steel, Korea Heavy Industries and Construction, Korea Gas, Korea General Chemistry, National Textbook, Korea Technology Banking, Daehan Oil Pipeline, and Korea District Heating). Details of the privatization and restructuring plans of these SOEs are summarized in Annex 2, Table 8; plans for some other SOEs are to be announced shortly. The implementation of the privatization program has been entrusted to a steering committee chaired by the Planning and Budget Commission and comprising officials of relevant line ministries. The steering committee will oversee the work of task forces established by each relevant line ministry. The task forces will also be responsible for studying and proposing changes to the existing regulatory framework.

2.70 **Privatization of Infrastructure Enterprises.** Several of the enterprises included in the July 1998 announcement are major infrastructure enterprises. While international experience confirms the potential efficiency benefits of infrastructure privatization, it also provides important lessons on the challenges involved. The SAL policy conditions, which focus on ensuring a sound regulatory and institutional framework for privatization, emphasize three key lessons. First, it is important to implement pro-competition structural and regulatory reform before privatization. While infrastructure sectors have traditionally been viewed as "natural" monopolies, it is possible to introduce competition in many activities, by removing regulatory barriers and restructuring incumbent enterprises. Such reforms are complex, but become still more difficult to implement once private property rights are involved. While Korea's telecommunications sector has been progressively liberalized, the power and gas sectors are dominated by large vertically-integrated monopolies. In power, the Government plans to restructure the industry by end-October 1998, before offering for sale a tranche of KEPCO shares by end-1998 and selling thermal power plants in 1999. Given the complexities of transition to a competitive power industry, this is an ambitious timetable. In gas, the Government plans to introduce an open access system by 2000 but complete a public offering in KOGAS by 1999. Again, this may prove ambitious. The Bank's advice in the SAL framework will be to ensure that the necessary pro-competition reforms and restructuring occur before the proposed privatization transactions and that the timetable is consistent with that.

2.71 Second, clearly defined rules that support investment, protect consumers and promote efficiency need to be established before privatization. Infrastructure enterprises that enjoy some degree of monopoly are typically subject to a range of industry-specific rules governing pricing, service quality, interconnection, and other matters. To support private investment, the rules need to assure investors of the opportunity to recover commercial returns. Rules also need to protect consumers from potential misuse of monopoly power and promote efficiency in investment, operation and final consumption. The rules governing Korea's infrastructure enterprises require substantial revision to meet these goals. In telecommunications, particular attention needs to be given to rules governing tariff rebalancing, interconnection arrangements, and the establishment of an efficient and equitable mechanism for financing universal service obligations. In power and gas, substantial revision of existing rules will be needed, to permit the introduction of more competitive market arrangements and of pricing structures that support efficient investment.

2.72 Third, it is increasingly recognized that the administration of regulation should be delegated to specialist regulatory bodies that operate in a transparent way and at arm's length from regulated enterprises and political authorities. The establishment of such independent regulatory bodies has become a hallmark of modern infrastructure reforms worldwide. Such bodies should be established as soon as possible before privatization to provide assurance to investors and consumers, to facilitate the transition from public to private ownership, and to allow time for training and other forms of regulatory capacity building. In Korea, regulatory rules are currently administered by line ministries, with pricing decisions also involving the Ministry of Finance and Economy and sometimes higher-level political authorities. The structure and startup strategy for more independent and specialist regulatory bodies will require early attention in the proposed reform of the telecommunications, power and gas industries.

2.73 **Private Participation in Greenfield Infrastructure Projects.** To reduce the burden of infrastructure financing on the public sector, and to promote enhanced efficiency in infrastructure provision, the Government will improve the regulatory and institutional framework for private participation in greenfield infrastructure projects. The Government has established a team to review Korea's current policies in this area to bring them into line with international best practices. Some of the key challenges for the Government will include: ensuring that proposed projects are well-conceived from an economic and financial standpoint, and form part of broader sector development strategies; ensuring an efficient allocation of risks between government, operators, and consumers; and ensuring that project procurement processes are transparent and provide a level playing field between bidders.

D. LABOR MARKET AND SOCIAL SAFETY NETS

2.74 The social sector policy agenda comprises two main elements: improving the functioning of the labor market to facilitate economic restructuring, as outlined in the preceding sections; and strengthening the social safety nets, both to mitigate the impact of the current crisis and structural change on the vulnerable and to make tangible, lasting improvements in Korea's system of social protection. Important actions were taken under SAL I in both these respects. Budgetary allocations for social safety net programs were substantially increased (para. 1.13). SAL II will build on this progress, taking into account the need to strengthen the social policy response in view of the sharper downturn in the economy.

Social Protection for Workers

2.75 **Labor Market Developments**. Unemployment has increased more sharply than expected, rising from a pre-crisis level of about 3 percent of the workforce to 7.4 percent (or 1.6 million workers) in August 1998. The largest job losses have occurred in construction (465,000) and manufacturing (650,000), with disproportionately greater losses experienced by female workers. Further increases in the unemployment rate are forecast, rising into the 8-10 percent range by the end of 1998 (or at least 1.8 million workers), and staying high during 1999 before recovering to levels around 5 percent in the years 2000 and 2001. This rise in open unemployment has been dampened by an increase in disguised unemployment. Some 460,000 people now work less than 18 hours a week, and an additional 180,000 workers are "on leave" without pay, while still counted as part of their firms' workforce. The measured increase in unemployment has been further moderated by a reduction of nearly 300,000 in the supply of active job seekers (especially among women).

2.76 Rigidities in the labor market continue to impede employment creation in the formal sector and push workers into marginal employment. The industrial relations system that developed during the period of rapid economic growth has led to high wages and overmanning in certain sectors, while resulting in oversupply and low wages in the rest of the economy. The large employment losses recorded in some sectors have been partly offset by increased employment in agriculture by 240,000 and among family workers (paid and unpaid) by 190,000. Restrictions on the use of dispatched or leased workers in manufacturing and a number of other occupations are an important impediment to labor market flexibility. Labor costs of dispatched workers average 40 percent less, and their employment can be adjusted flexibly according to production needs. Wage differentials among regular employees are also suggestive of the segmentation of the Korean labor market. Monthly labor earnings average W1.7 million for large companies (more than 500 employees) compared to W1.2 million for companies with 10-29 employees and only W600,000 for companies with fewer than 5 employees.

2.77 **Responding to the Rise in Unemployment.** The focus of labor market policy should be on measures that are likely to be sustainable over the medium term in an environment of high unemployment. Policy design should aim to keep the natural rate of unemployment low by enhancing flexibility in labor allocation, providing cost-effective means to facilitate re-employment, and offering temporary income support through unemployment insurance. In line with this approach, some important steps were taken under SAL I, including legislation enacted in February 1998 that permitted layoffs and expanded unemployment insurance. SAL II will support significant additional reforms.

2.78 First of all, to support corporate and financial sector restructuring, it is important that the February *legislation legalizing layoffs* is fully implemented. The settlement of the Hyundai Motor labor dispute in August, where in the face of strong resistance from the unionized workforce the new layoff law was not fully enforced, had a major adverse impact on investor confidence. Similar pressures are likely to arise as other major corporations and financial institutions, where unionization is high, undertake restructuring. The Government will need to stand firm. Under SAL II, the Government has renewed its commitment to fully enforce the layoff provisions of the February legislation. Another legislation passed in February, as part of SAL I, legalized the operation of *manpower leasing* services. However, the use of dispatched or leased manpower in direct production processes in manufacturing was not permitted (except with union agreement). Later in June, a Presidential Decree was issued which further limited the use of leased workers to a positive list of 26, mostly white collar occupations. There are also limitations on the term of contract workers. These restrictions constrain labor market flexibility and should be removed. Besides economic efficiency, there is an equity argument for removing these labor market rigidities as they protect the interests of a minority of the workforce that is unionized at the expense of the interests of the vast majority of workers who are not unionized and who typically earn much less.

2.79 With respect to policies to promote re-employment, care needs to be taken to ensure that expanding public *employment services* does not crowd out those provided privately so as to ensure efficient complementarity between public and private provision of employment services. The rapid expansion planned in public employment offices, from 53 in 1997 to 162 in 1999, risks undermining the potential synergy with private employment services that already play an important role in the labor market. In 1997 private employment services placed 1.8 million workers compared to less than 0.3 million by public employment offices. More than 80 percent of workers assisted by private employment offices are engaged in elementary and service occupations that usually attract less privileged workers.

2.80 Other *active labor market policies* comprise the Vocational Ability Development (VAD) and Employment Security (ES) schemes (such as training and retraining, wage subsidies for reduced hours, relocation of employment, etc.) provided under the payroll-tax financed Employment Insurance System (EIS). The experience of other OECD countries suggests that active labor market measures such as vocational training may not be cost-effective, achieving only limited net effects while imposing high deadweight losses. Indeed, wage subsidies to non-viable establishments obstruct efficient corporate restructuring. Unnecessary payroll taxes also have undesirable disincentive effects on firms and workers. Accordingly, SAL II calls for the cost-effectiveness of the VAD and ES programs to be evaluated and inefficient programs amended or dropped, while limiting these programs in the interim.

2.81 Supported by SAL I, the provision of temporary *income support* for the unemployed was augmented in mid-1998 by extending the Unemployment Insurance (UI) provisions of EIS to firms employing more than 5 workers (previously only firms with more than 30 workers were covered). While this raised coverage to a total of 6.2 million workers, most workers remained uncovered by UI (formal, insurable labor force is about 13 million). As part of SAL II, legislation has been passed that will further expand UI coverage to firms with fewer than 5 workers and to temporary and part-time workers with effect from October 1998. This will raise UI coverage approximately by an additional 2.5 million workers. Moreover, the Government has implemented enhancements in the benefit structure. The duration of insurance benefits was increased by two months for all categories of eligibility, with the minimum duration extended to four months. The minimum replacement rate was raised from 50 to 70 percent of the minimum wage. To maintain the financial viability of the UI scheme, given these benefit enhancements and the increased risk of unemployment, the payroll contribution rate has been increased from 0.6 to 1 percent. However, a further increase in the contribution rate to 2 percent or higher may be necessary to prevent a depletion of UI reserves in 1999.

Protecting the Poor

2.82 In the past, Korea has successfully relied on rapid growth and near-full employment to provide an adequate standard of living for the population. In 1996, only 1.5 million people were recipients of the means-tested *Livelihood Protection Program* for the poor. Livelihood Protection provides a range of welfare benefits, including cash income support to the disabled poor and Medical Aid and some other benefits (e.g., education) to all beneficiaries. With the sharp drop in employment and incomes, the number of poor and vulnerable needing public assistance is rising, and new programs have been initiated to expand coverage and diversify the content of the social safety net. Within the SAL framework, the Government is committed to allocate sufficient budget to protect expenditures under the existing Livelihood Protection program in real terms, taking into account the increase in poverty.

2.83 A large increase in poverty incidence is likely to occur during 1998, and continue in 1999. At least one-third of the unemployed, or some 600,000 workers, are expected to have incomes less than the poverty line. Including family members, this implies that an additional 2.4 million people could become poor. This effect could be magnified if the role of private transfers in providing an informal safety net, especially for the elderly, contracts substantially in the wake of the crisis. Such developments highlight the need for increased budgetary expenditure on safety net programs to prevent the rising numbers of the unemployed and their dependent family members from falling into poverty. These programs need to be designed to maximize their effectiveness in poverty reduction, but also to minimize the potential for creating work disincentives. Thus it will be important to strengthen the database for monitoring trends in the number of crisis-induced vulnerable households, and for assessing the effectiveness of programs to reach those in need.

2.84 In May 1998, supported by SAL I, the Government implemented a new *workfare program* targeted at the unemployed. Phase I of the program provided temporary employment for some 75,000 workers, out of around 130,000 applicants. Phase II of the program began in August 1998 and is expected to absorb up to 150,000 workers, out of at least 200,000 applicants. Given the excess supply of labor already forthcoming at the public works wage rates, SAL II supports a further expansion of this program. There is likely to be a substantial increase in demand for temporary workfare as unemployment continues to rise, with unemployment insurance either not available or not yet effective for some and lapsing for others. The excess supply of labor also signals the importance of keeping wage rates low in order to maximize self-targeting to poor applicants. The public works wage rate is lower than the prevailing market wage for comparable activities, but is higher than the minimum wage. The Government will need to resist pressures to allow wages to drift upwards.

2.85 The Government also introduced a new *noncontributory means-tested unemployment allowance* in April 1998 targeted at the uninsured unemployed with incomes and assets below a defined threshold, an initiative supported by SAL I. The current budget provides for 310,000 applicants for this allowance. This figure is well below the size of the eligible target population, which is increasing and is likely to number at least 600,000. Accordingly, SAL II supports an expansion of this program. Also, it calls for the amount of assistance per family to be set at a level that avoids adverse work incentives and facilitates self-selection.

Financial Risk Management for Health

2.86 Health-related financial risks are an important factor affecting household welfare. The affordability of major financial risks is deteriorating in the face of adverse income shocks. Currency depreciation has raised the price of pharmaceuticals with significant import content. These shocks call for improved management of health-related financial risks, especially in protecting the poor from suffering financial catastrophe in obtaining medical care. The main policy instruments for managing health-related financial risks in Korea are the Medical Insurance System (MIS) funded by mandatory social insurance contributions, and the budget-financed Medical Aid Program (MAP) for poor beneficiaries of the means-tested Livelihood Protection program. Since 1989, these risk management arrangements have achieved near-universal coverage in terms of enrollment: roughly 95 percent of the population is enrolled in MIS and the remaining 5 percent in MAP. But universal enrollment does not entail comprehensive coverage of financial risks. Instead, the Korean health insurance system is noted for its high coinsurance rates, which can impose a heavy burden of out-of-pocket costs on patients, especially the poor. The introduction of more efficient and equitable risk management mechanisms, as envisaged in SAL II and outlined below, is an important objective of social policy during adjustment.

2.87 Reforms to MIS to achieve better risk management span two issues. First, the fragmented organization of some 370 small health insurance funds results in a high average administrative cost ratio of 8.5 percent, ranging up to 16 percent. These leakages to administrative costs reduce the funds available for pooling financial risks among members. The Government is evaluating options for organizational consolidation that would enhance risk-pooling capacity. Second, measures are being considered to close the gap between nominal and effective coinsurance rates, especially for low-probability but high-cost inpatient care. The nominal coinsurance structure efficiently assigns differential coinsurance rates between low-cost outpatient and high-cost inpatient care. A hospital outpatient visit requires a deductible plus 55 percent coinsurance while an inpatient stay requires a 20 percent coinsurance. In reality, however, estimates indicate that the effective coinsurance rate for hospital inpatient services is much higher, averaging more than 40 percent and ranging up to 70 percent for services such as obstetrics and gynecology. This divergence results from the exclusion of Special Treatment Charges (STCs) for covered services, as well as certain non-covered services, from the regulated fee-for-service reimbursement structure. As a result, Korea's private financing ratio is one of the highest in the world at 69 percent of aggregate health expenditure, considerably greater than the averages for East Asia (49 percent) and OECD (26 percent).

2.88 The MAP faces similar reform issues in reducing effective coinsurance rates for poor beneficiaries of Livelihood Protection. Only the minority of beneficiaries confined to home or institutions are covered by Class I Medical Aid, which finances 100 percent of regulated patient charges, but does not pay for additional STCs and non-covered services. The majority are enrolled in Class II Medical Aid, which requires a 50 percent coinsurance, plus extra STCs and non-covered charges. Beneficiaries of both classes suffer the additional disadvantage of discrimination by providers resulting from the lack of harmonization of government-regulated fee-for-service provider reimbursement levels, which are lower for MAP than MIS.

Pension System Reform

2.89 The reform of Korea's pension system is motivated by several objectives: the social goal of securing adequate income support for the elderly, especially the elderly poor in the present crisis; the fiscal need to ensure the financial viability of the pension schemes; and the broader economic objectives of developing the capital market (and thereby help reduce the heavy reliance on bank debt and facilitate corporate restructuring) and supporting an efficient labor market.

2.90 Since the National Pension Scheme (NPS), which covers most private sector workers, was introduced only in 1988 and has not yet matured, the present generation of elderly Koreans must depend on their own earnings, savings and family support for their livelihood. For many, this will be insufficient to prevent poverty, and social assistance is therefore required. Under SAL I, a means-tested non-contributory "social pension" for the needy elderly was introduced. To ensure the adequacy of this scheme, SAL II will support an expansion of its coverage and benefits. In order to effectively target limited resources, the impact of the scheme will be carefully monitored.

2.91 In the short run, fiscal pressures from pension outlays will come from the special occupational schemes which have now matured and will soon begin to run deficits. The civil servants scheme in particular will face financial difficulties soon. The fact that the finances of these schemes are not clearly reported in the fiscal accounts, and the dearth of actuarial projections, mask a growing fiscal threat. As a first step in the process of reforming occupational pensions, SAL II will support improvements in the accounting and actuarial assessment of these schemes.

2.92 The financial position of the NPS is much more favorable in the short term as it continues to run significant surpluses. However, in the longer run, the current relationship of contributions to benefits is likely to lead to large deficits. Motivated by SAL I, important legislation reducing benefits and increasing contributions has been prepared. These changes, however, will not completely eliminate deficits and establish actuarial balance in the long run, implying the need for further reform. Deficits in NPS would occur sooner if its reserves (now at more than seven percent of GDP) are not efficiently invested. Within the SAL framework, the Bank is supporting improvements in the transparency and efficiency of NPS fund management. The measures include phasing out forced lending to government from the pension fund reserves, applying economic criteria to investments, and introducing more professional asset management. These reforms would both help NPS financial performance and contribute to capital market development.

2.93 The NPS is likely to be the most important component of Korea's system of old age income security in the next century and reform efforts have naturally focused on it. Nevertheless, the special occupational pension schemes, mandatory retirement allowances, and tax-favored individual retirement savings are also important components of the overall system. Millions of workers have acquired rights to retirement allowance payments whose magnitude is large and which will need to be handled in the difficult setting of widespread corporate distress. An appropriate framework for voluntary private pensions needs to be put in place, and tax and regulatory issues relating to pensions need to be addressed. Future reform of the pension system needs to give private management and funded pensions a larger role in the system, strengthening links to the capital market. These elements must be integrated into an overall, coherent reform package aimed at developing an efficient, equitable and financially sustainable pension system. As envisaged in SAL I, and supported by SAL II, a Task Force is being established to prepare a White Paper on options for an integrated pension reform for public debate.

III. BANK GROUP STRATEGY

A. THE BANK

3.1 The structural reform program described in the preceding section is grounded in a medium-term framework. The Bank is supporting this medium-term reform effort through a series of structural adjustment loans linked to progress on the reforms. As part of the $57 billion international support package for Korea from multilateral and bilateral sources agreed in December 1997, the Bank undertook to provide up to $10 billion in assistance. The proposed SAL II in an amount of $2 billion is the third Bank loan to be provided within this framework, following a $3 billion Economic Reconstruction Loan (ERL) disbursed in December 1997 and a $2 billion Structural Adjustment Loan (SAL I) disbursed in March 1998.

3.2 **Strategic Priorities and Lending Program.** The Bank program is designed to support Korea's strategic priorities in the wake of the crisis: restoring macrofinancial stability while minimizing the costs to the real economy and the impact on the vulnerable; and addressing the underlying causes of the crisis through a program of structural reforms that would lay the basis for Korea's return to high and sustainable growth. Accordingly, the lending program includes a series of fast-disbursing loans that both provide quick financing and support the needed structural reforms while cushioning the impact on the poor and the vulnerable.

3.3 The Government recognizes that a major restructuring of the incentives and institutional framework is needed to deal with the problems in the financial and corporate sectors and to sustain strong and stable growth in today's more integrated and competitive global economy. Also, the system of social protection needs to be strengthened to limit the social costs of adjustment. Building on SAL I, the proposed SAL II supports reforms in three areas central to this effort: (i) financial sector restructuring and development, including capital market development; (ii) corporate sector reform, including corporate debt restructuring, reform of corporate governance and competition policies, and reform and privatization of state-owned corporations, especially in infrastructure sectors; and (iii) labor market reform and strengthening of social safety nets. Future lending operations would continue to support a deepening and extension of reforms in these key areas. In addition to follow-up structural adjustment lending, the use of SECALs or guarantee operations is a possibility.

3.4 **Technical Assistance and Non-Lending Services.** To assist in the design and implementation of reforms supported by the adjustment operations, many of which require specialist expertise, the Bank has initiated a major program of technical assistance. Technical assistance is being provided through several means: in the process of preparation and supervision of the adjustment operations themselves; through a $48 million technical assistance loan for financial and corporate sector restructuring (FCRAL) approved in August 1998; through technical assistance supported by grant funds, recently augmented by the ASEM program; through economic and sector work on selected topics designed to strengthen the analytical underpinnings of the lending operations; and through ongoing policy dialogue. Both EDI and DEC are being actively involved in the TA/training and dissemination activities. Active collaboration has also been developed with Korea's well-regarded think tanks. Several important seminars have been organized in Seoul, on major issues of reform and on lessons learned from the Korean crisis and their relevance to other countries. A major international conference on Democracy, Market Economy and Development has been arranged for February 1999, to be inaugurated jointly by President Kim Dae-Jung and Mr. Wolfensohn.

3.5 **Special Emphasis on Social Programs.** An important element of the Bank's program of support will be the strengthening of Korea's system of social protection. Of immediate priority are measures that would cushion the short-term impact of the crisis and structural adjustment on the poor and the vulnerable—protection of pro-poor expenditures in the budget and measures to assist unemployed workers. But the Bank is also supporting a longer-term agenda of actions that would produce lasting improvements in Korea's system of social protection. These include the strengthening of the information base for poverty monitoring and targeting; improvement of the unemployment insurance system and related labor market information; and reform of the pension system, including related reform of health insurance. This agenda would be supported both within the framework of the SALs and through technical assistance and other non-lending services. Support to the social sector agenda would be a major focus of the ASEM program, and a range of proposals for analytical work and technical assistance have been developed for funding under that program.

3.6 **Implementation.** Delivering a high-quality, high-speed program of this magnitude requires a substantial commitment of staff and budgetary resources. The Bank has moved swiftly to respond to the client's needs in a crisis situation. The first $3 billion loan was disbursed within three weeks of the client's request. The subsequent SALs have also been prepared on a fast track. The monitoring of macroeconomic and financial developments has been strengthened. A new Korea country unit was created in January 1998. It is located in the field to maximize client responsiveness and achievement of results on the ground. While the core country team remains small, best available expertise is being tapped from all over the institution to staff strong task teams, supplemented by outside expertise. The financial sector work is being conducted by a team from the new Special Financial Operations Unit, within the framework of the country assistance strategy.

3.7 The country assistance program will be fleshed out further through discussions with the Government which are continuing. A short and focused country assistance strategy (CAS) is being prepared, which will set out the planned lending and non-lending activities and their sequencing within an overall country strategic framework.

3.8 Of the loans made by the Bank to Korea prior to its graduation from Bank borrowing in FY95, involving a total commitment of about $8.7 billion, nine remain active, with an undisbursed balance of about $225 million. Their implementation status is rated as either "satisfactory" or "highly satisfactory." Prior to the ERL, outstanding loans to Korea amounted to $1.9 billion. Outstanding loans now amount to $6.9 billion. The status of Bank Group operations in Korea is detailed in Annex 3.

B. International Finance Corporation (IFC)

3.9 Prior to the onset of the Asian financial crisis, IFC had not been active in Korea for the preceding ten years, its last investment having been made in 1988. The crisis has resulted in a strong potential role for IFC and the Corporation is now re-engaging actively in Korea. IFC aims to follow a flexible approach in Korea, responding to the changing needs of the market as well as individual institutions, delivering technical assistance, new products or investments as needed at various stages of the country's recovery. In the immediate future, a major element of IFC's strategy is to assist in the restructuring of Korean corporates and financial institutions which will directly aid the recovery of these institutions as well as the economy.

3.10 In FY98, IFC provided about $245 million through four transactions in the financial sector. Since the banking system accounts for a significant part of the Korean financial system and its recovery is important for public confidence, IFC has provided about $175 million in financing to strengthen two existing client banks and arranged a $100 million trade financing facility as well. To support corporate restructuring and long-term venture investments, IFC is mobilizing foreign equity capital through a $100 million private equity fund. IFC is also undertaking strategic investments in companies with strong fundamental business prospects and is currently processing about ten projects in the general manufacturing, agribusiness and petrochemicals sectors, and expects to provide about $250 million in financing for these projects. Given the current high level of demand for IFC financing and range of opportunities, IFC has reassigned several staff to working on Korea and is co-locating a small contingent of IFC staff in the World Bank's new Resident Office in Seoul.

3.11 Since its first investment in 1968, IFC has made gross commitments totaling about $455 million of which about $125 million is currently outstanding.

C. MULTILATERAL INVESTMENT GUARANTEE AGENCY (MIGA)

3.12 Korea joined MIGA in April 1988. So far, MIGA has not issued any guarantees in Korea. MIGA has received one Definitive Application for a financial sector project and five Preliminary Applications for projects in financial services, power and the manufacturing sector. Korea has benefited from MIGA's technical assistance and promotional services. Over 80 Korean organizations are users of MIGA's Internet-based market place, IPAnet, which promotes investment in emerging markets by serving as an on-line information exchange among public and private organizations. MIGA is strengthening its relationship with the Korean Trade and Investment Promotion Agency (KOTRA). It will continue to offer its full range of services to Korea, in investment promotion and in capacity-building for public and private organizations involved in investment promotion, for which there is likely to be increased demand in the wake of the crisis.

D. COORDINATION WITH IMF AND ADB

3.13 The Bank has been working closely with the IMF since the onset of the crisis, in monitoring macroeconomic and financial developments, advising the Government on the response to the crisis, and coordinating our support. The preparation of SALs has been coordinated closely with the Fund stand-by arrangement to ensure consistency and complementarity, with active collaboration between the two staffs both at headquarters and in the field through parallel missions. Implementation under the 3-year, SDR 15.5 billion stand-by arrangement is on track. Given its mandate, the Fund has taken the lead in the dialogue on macroeconomic stabilization measures. The Fund has also spearheaded the dialogue on trade policy and capital account liberalization. In the financial sector, both the Bank and the Fund have been actively involved, with the division of labor guided by their respective mandates and comparative advantage. The Bank has taken the lead in other areas of structural reform, including corporate sector reform (corporate restructuring, corporate governance, competition policies, privatization), and labor market reform and social protection.

3.14 As part of the $57 billion international financing package for Korea from multilateral and bilateral sources, the Asian Development Bank (ADB) undertook to provide up to $4 billion in adjustment financing and $15 million in technical assistance in support of financial sector restructuring and development. Of the

$4 billion committed, $3 billion has so far been disbursed. As with the IMF, the World Bank is coordinating closely with the ADB in its financial sector work.

IV. THE LOAN

4.1 The proposed loan is consistent with the Bank's country assistance strategy outlined above. The Government has prepared and submitted a Letter of Development Policy requesting Bank support for a strong structural adjustment program aimed at achieving durable financial stability and laying the basis for resumption of strong, sustainable growth. The reform program, prepared in close cooperation with the Bank, is described in detail in the Policy Matrix attached to the Letter of Development Policy (Annex 1).

A. BOARD PRESENTATION AND TRANCHE RELEASE CONDITIONS

4.2 The full program of policy actions to be supported by SAL II is set out in the SAL II Policy Matrix (Annex 1). Within this full program, a subset of key policy actions has been identified as conditions for Board presentation and second tranche release. Besides the implementation of these specific policy actions, a general condition will be that the implementation of the full program is satisfactory overall.

4.3 **Conditions for Board Presentation**. Within the full program detailed in the Policy Matrix, the following were identified as conditions for Board presentation, all of which have now been met:

1. Adoption of objectives and principles acceptable to the Bank to be used by the Government in making decisions on the implementation plans of the seven undercapitalized banks, and other banks so identified, including the provision of financial support by the Government.

2. Agreement between the Government and the lead manager selected for the privatization of Korea First Bank and Seoul Bank on the general deal structure (including confirmation to the Bank of the modalities of provision of public support), and authorization to the lead manager to contact investors.

3. Adoption of principles acceptable to the Bank governing the use of public resources in financial system restructuring and recapitalization.

4. Issuance of guidelines to financial institutions by FSC, satisfactory to the Bank, limiting the extension of "emergency" loans to corporations.

5. Commitment to establish an independent accounting standard setting organization by June 1999.

6. Adoption and announcement of an overall strategy acceptable to the Bank for dealing with structural, regulatory and institutional issues in privatization and SOE reform in infrastructure sectors, including, inter alia, the priority to be given to transition toward more competitive market structures and establishment of appropriate regulatory structures, and sequencing of structural, regulatory and ownership reforms.

7. Extension of unemployment insurance to firms with fewer than five workers and to temporary and part-time workers, with effect from October 1998.

8. Adoption and announcement of a timetable agreed with the Bank for the reduction of forced government appropriation of the flow of National Pension Fund surpluses, and announcement of the Government's commitment that the stock of its outstanding borrowings from NPF will be repaid in full at maturity without rollovers.

4.4 **Conditions for Second Tranche Release.** Within the full program detailed in the Policy Matrix, the following will serve as conditions for release of the second tranche, in addition to the general requirement of overall satisfactory progress in carrying out the full program.

1. Maintenance of a sound macroeconomic framework, consistent with the objectives of the Program, as determined on the basis of indicators agreed to by the Government and the Bank.

2. In consultation with the Bank, adoption of process and principles necessary to ensure that adequate public resources will be made available by the Government for use in financial system recapitalization and restructuring.

3. Achievement of progress, satisfactory to the Bank, toward sale by the Government of majority ownership in Korea First Bank and Seoul Bank through a biding process satisfactory to the Bank.

4. (a) Adoption by KAMCO of principles, acceptable to the Bank, for the disposition of troubled assets acquired by KAMCO, including the sale of a majority of assets within three years of acquisition. (b) Adoption of procedures, sources and instruments of funding for KAMCO acceptable to the Bank.

5. (a) Adoption and issuance by FSC of improved accounting and auditing standards for financial institutions, listed companies and joint stock companies consistent with international best practice and prepared with participation of representatives of internationally recognized accounting firms, and institution and announcement of the requirement that financial statements of financial institutions, listed companies, and joint stock companies with assets in excess of W7 billion will be prepared and audited in accordance with these standards from fiscal year 1999. (b) Adoption and announcement of an implementation plan acceptable to the Bank for the establishment of an independent accounting standard setting organization by June 1999.

6. Adoption and announcement of a plan and schedule acceptable to the Bank for the institution of a requirement for the establishment by listed companies of audit committees of boards of directors, and completion of a draft of necessary changes in laws and regulations to give effect to this requirement.

7. Enactment of amendments to the Fair Trade Act, acceptable to the Bank, to enhance competition in the domestic economy, based on the recommendations of the Joint Public/Private Sector Committee.

8. Enactment of the Act on Comprehensive Regulation of Cartels.

9. Enactment of legislation, satisfactory to the Bank, modifying restrictions under the Fair Trade Act on the creation of holding company structures so as to permit such structures subject to conditions to avoid undue ownership concentration.

10. Achievement of progress, satisfactory to the Bank, on enhancement of labor market flexibility.

11. Allocation of amounts in the 1999 budget sufficient to: (a) expand the public works program to absorb the supply of labor forthcoming at targeted wage levels (not higher in real terms than under Phase II of this program); (b) expand the provision of means-tested non-contributory income support for the unemployed poor in line with the increase in the eligible target population; (c) expand workfare and other forms of income support for able-bodied beneficiaries of "self-support" under the livelihood protection program; and (d) at least maintain in real terms the level of expenditure per beneficiary under the existing livelihood protection programs for the poor.

12. Implementation of the phased reduction of forced government appropriations from the National Pension Fund agreed with the Bank, through adoption of legislation satisfactory to the Bank, including necessary revisions to the Public Fund Management Act.

B. LOAN ADMINISTRATION

4.5 **Terms and Conditions.** At the request of the Government, the proposed loan would be a Single Currency Loan in US Dollars, with a fifteen-year maturity including a five-year grace period. The loan amount proposed is US$2 billion, to be disbursed in two equal tranches. The interest rate on the loan would be six-month US Dollar LIBOR, reset semiannually, plus 75 basis points. A service charge of 1.5 percent of the loan amount would be payable on effectiveness, financed out of the proceeds of the first tranche and amortized over the life of the loan. Standard terms would apply to commitment fee and prepayment. The Borrower would be ineligible for current or future waivers of interest or commitment charges.

4.6 **Disbursement.** The Government will open and maintain a deposit account with the Bank of Korea (BOK). Upon effectiveness, and upon satisfaction of second tranche release conditions, the Government will submit a simplified withdrawal application to the Bank, against which the Bank will disburse tranche proceeds into the Deposit Account. Disbursements will not be linked to specific purchases, and supporting evidence for disbursements is therefore not required. The proceeds of the loan will not be used to finance expenditures typically excluded under the Loan Agreement (local expenditures, military, drugs, nuclear, etc.).

4.7 **Accounts and Audit.** Upon the Bank's request, the Government will have the Deposit Account audited by independent auditors acceptable to the Bank and will furnish to the Bank a certified copy of the audit report no later than four months after the Bank's request.

C. BENEFITS AND RISKS

4.8 **Benefits.** Besides helping Korea effectively overcome its external financial crisis and restore investor confidence, the proposed loan will support a major program of structural reforms in the financial and real sectors, building on SAL I and maintaining the momentum of reform. The program involves a deepening of reforms in three key areas: financial sector restructuring and development, including capital market development; corporate sector reform, including corporate debt restructuring, reform of corporate governance and competition policies, and privatization; and labor market reform and the strengthening of social safety nets. Together, these reforms imply a radical restructuring of the incentives and institutional framework influencing the behavior of all major actors in the economy—financial institutions, businesses, labor, policy makers—a restructuring that would foster financial soundness, increase corporations' exposure to market discipline, enhance competition (domestic and foreign), and open up the labor market to increased flexibility. This shift is necessary to underpin financial sector stability, promote increased real sector efficiency and competitiveness, and lay the basis for Korea's return to a path of strong and sustained growth in the context of today's more integrated and competitive global economy.

4.9 The proposed loan will strengthen social programs to cushion the impact of the crisis and structural adjustment on the vulnerable. Besides the provision of support to the poor to tide over a difficult period, the reform program will make lasting improvements in the social safety net—unemployment insurance system, targeting of poverty programs—and initiate a reform of the country's pension system and health insurance.

4.10 In sum, the proposed SAL II, which forms part of an internationally coordinated support package for Korea, will both help Korea consolidate its recovery from the financial crisis and assist in the necessary post-crisis remodeling of its economy. The region, and the international financial system at large, will also benefit from a quick restoration of market confidence and recovery of growth in Korea.

4.11 **Risks.** Korea has made significant progress in restoring stability to the foreign exchange market and strengthening its external financial position. However, investor confidence remains fragile and the external position still is vulnerable to major shocks. There are risks in the external environment, especially those relating to the regional situation, e.g., developments in Japan. Mitigating these risks is the firmness the Government has demonstrated in implementing tough macroeconomic policies in response to the crisis, which inspires confidence in the Government's macroeconomic crisis response ability. The rebuilding of international reserves since the crisis also provides a cushion against shocks, as does the restructuring of foreign liabilities toward longer maturities. The provision of additional adjustment financing by the Bank through the proposed loan, and the structural reforms conducive to restoration of Korea's competitiveness and foothold in export markets that the loan would support, would provide further comfort to markets.

4.12 The fragility of the banking system and high corporate leverage are major sources of vulnerability in the Korean economy. Accordingly, addressing these vulnerabilities through financial and corporate sector restructuring forms the core of the program supported by the proposed loan. The required restructuring, however, will be a difficult process and risks of slippage cannot be ignored. The risks arise from several factors: pressures from vested interests that militate against deep restructuring and could lead instead to a "muddle-through" approach; inefficient, non-transparent use of public resources that accentuates moral hazard and results in large fiscal costs without achieving meaningful, durable restructuring; weak financial system and corporate governance; or inadequate implementation capacities. The proposed program mitigates these risks by putting in place a clear, monitorable framework for financial and corporate sector restructuring, building in appropriate incentives and safeguards; by setting out clear criteria for public resource use; by supporting complementary actions to improve financial system and corporate governance; and by providing technical assistance to both regulatory and supervisory authorities and to units in banks specially set up to negotiate corporate debt workouts (supported by the FCRAL).

4.13 There is also a general risk that political factors may cause the reform effort to slow. There can be several sources for such risks: shifts in the balance of power between the ruling and opposition parties; severity of the economic downturn causing political support for reform to unravel; increasing labor union militancy as unemployment rises; and a premature sense of complacency as the external financial situation improves. The strong commitment to reform demonstrated by the Government so far, reflected in the implementation of some major and politically difficult reforms, provides assurance against these risks. True, union militancy has increased, but union actions so far have failed to attract wider public support, and the Government has committed to stand firm in defense of its pro-reform agenda. The Government, supported by the Bank program, is taking strong measures to strengthen the social safety net, and has followed a participatory approach in designing important policy responses through a tripartite forum bringing together government, business and labor representatives, measures that contribute to preserving the social consensus for reform.

D. IMPLEMENTATION AND MONITORING

4.14 Korea has a strong track record in the implementation of its undertakings with the Bank. Implementation of the ongoing portfolio of nine investment projects is consistently rated as either satisfactory or highly satisfactory. Commitment to implementation is also reflected in the progress made so far under the recent adjustment loans. The proposed SAL II which supports a major reform agenda contains strong prior actions in all the key areas of reform. The two-tranche design of SAL II will also help with implementation and monitoring. Implementation will be monitored through regular reviews. Additionally, dialogue on follow-up Bank operations would provide the occasion to assess implementation and outcomes.

4.15 Implementation will be supported by provision of technical assistance in the design and execution of envisaged reform, most importantly through the recently approved FCRAL which focuses on the difficult areas of financial and corporate sector restructuring. As in the case of recent adjustment loans, the Letter of Development Policy includes clear undertakings by the Government to provide the Bank relevant and timely information on all areas covered by the program to facilitate monitoring of progress. The location of the Bank's Korea country unit in the field also facilitates effective monitoring.

V. RECOMMENDATION

5.1 I am satisfied that the proposed loan complies with the Articles of Agreement of the Bank and I recommend that the Executive Directors approve it.

James D. Wolfensohn
President

by Sven Sandström

Washington, D.C.
October 2, 1998

Annexes

ANNEX I

LETTER OF DEVELOPMENT POLICY

Seoul, Korea
September 24, 1998

Mr. James D. Wolfensohn
President
International Bank for Reconstruction and Development
Washington, D.C., 20433

Dear Mr. President:

SUBJECT: PROPOSED SECOND STRUCTURAL ADJUSTMENT LOAN

Letter of Development Policy

1. In response to the economic crisis, the Korean Government embarked on a major structural reform program last December. Since then, we have made substantial progress in the implementation of this reform program, despite a difficult macroeconomic setting and associated social and political pressures. Our commitment to structural reform reflects our conviction that the response to the crisis must not just deal with its immediate symptoms but address its root causes. We fully recognize that fundamental reforms are needed in the incentives and institutional framework to restore Korea's economic performance in today's more integrated and competitive global economy.

2. Our economic reform program has two main objectives: restoring macrofinancial stability while limiting the costs to the real economy and the impact on the vulnerable; and strengthening the economy's structural foundation to lay the basis for resumption of strong and sustainable growth. We have made considerable progress in restoring stability in the foreign exchange market and rebuilding external reserves. However, the impact of the crisis on the domestic economy has been severe. We have responded to this situation by adjusting our macroeconomic policies to mitigate the severity of the recession and support an early recovery of domestic demand, consistent with sustaining the hard-won gains in restoring external financial stability. We will continue to work closely with the IMF in ensuring that our macroeconomic policy framework remains sound and responsive to the economic situation. In the area of structural reform, where we are working closely with the World Bank, we have intensified our efforts in all keys areas of reform, including the reform of the financial system, restructuring of the corporate sector, and strengthening of social safety nets.

3. In the design and implementation of our structural reform program, we have received important support from the World Bank, first through an Economic Reconstruction Loan (ERL) and then a Structural Adjustment Loan (SAL). In recent weeks, we have held intensive discussions with the World Bank, and have reached a common understanding on the next stage of reforms. Details of policy actions that we will take under the reform program agreed with the Bank are provided in the attached Policy Matrix. As you will see, these actions constitute a strong and comprehensive reform program. We seek World Bank support for this program through a Second Structural Adjustment Loan.

4. Building on the progress made under the previous loans, the program described in the Policy Matrix aims to achieve a major deepening of reforms in three key policy areas: financial sector reform; corporate sector restructuring; and labor market reform and strengthening of social safety nets. In all of these areas, the program includes substantial up-front actions. While the details are provided in the Policy Matrix, allow me to highlight some important elements of the reform program.

5. In the *financial sector*, we are giving priority to the resolution of troubled financial institutions, but are also taking steps to improve the regulatory and institutional framework to support sound development of the financial system in the future. The program includes the following main elements: resolution of weak financial institutions, especially banks, based on a timetable and decision criteria on resolution options agreed with the Bank, and supported by diagnostic reviews and assessment of bank rehabilitation and implementation plans; adoption and application of principles and processes, agreed with the Bank, for the use of public resources in financial sector restructuring and recapitalization and for the management of the acquired assets; enhancement of the independence, authority and institutional capacity of the agency charged with consolidated supervision of the financial sector—FSC; strengthening of prudential regulations, especially those relating to large exposures and connected lending; and development of the capital market through encouragement of new institutional investors (e.g., mutual funds) and asset securitization, standardization of government bond issues, and strengthening of securities market prudential rules and self-regulated organizations.

6. In the *corporate sector*, we have established, in consultation with the Bank, a framework for corporate debt workouts led by creditor banks under guidelines established by the FSC and linked to financial sector restructuring. The workout process will be supported by policies to limit "emergency" loans; reduce cross-guaranties; facilitate debt-equity swaps, asset sales, and mergers and acquisitions; remove tax disincentives; and further improve insolvency laws and procedures. We will ensure that corporate debt restructuring takes place in a market-based manner, through voluntary workouts between corporations and their creditors subject to the rules and guidelines that have been established by the FSC and are described in the Policy Matrix. We will promote corporate restructuring vehicles that are privately financed and managed. We will avoid direct government interventions in the corporate restructuring process that can be distortive and that entail moral hazard. The Government has announced on September 8, 1998 that it will not entertain any demands from the *chaebol* for special financial or fiscal privileges, such as from the top five *chaebol* in support of the recently announced mergers of some of their industrial units known as "big-deals," that depart from the discipline and transparency of the framework for corporate restructuring agreed with the Bank and described in the Policy Matrix.

7. To restore, and sustain, financial viability and competitiveness, Korean firms need both financial and real restructuring. The latter requires improvements in the governance of firms and increased exposure to competitive pressures. Our program for improvements in corporate governance includes strengthening of the responsibilities, independence and accountability of corporate boards; enhancement of minority shareholder and institutional investor rights; and improvement of the legal framework for creditors' rights. Financial transparency and accountability will be enhanced by the adoption of accounting, auditing and reporting standards for financial institutions and corporations that are consistent with international best practice, strengthening of the internal audit function and the financial oversight role of boards of directors, and enhancement of the role of independent professional bodies in standard-setting and oversight in accounting and auditing. Policies to enhance competition will include strengthening the Fair Trade Act and its enforcement; tightening the regulation of cartels and preventing collusion; ensuring a competitive framework for *chaebol* restructuring; further liberalizing foreign investment; and simplifying import certification procedures. The establishment of holding companies will be allowed in order to provide a more transparent ownership framework for corporate groups.

8. Building on the understandings reached under SAL I, the Government has initiated a major program of reform and privatization of state-owned corporations. The program includes opening the major infrastructure sectors to private participation. In this regard, an important focus of our policy will be the timely implementation of regulatory and institutional reforms in the infrastructure sectors to be privatized in order to ensure that the planned privatization takes place in a transparent and competitive framework and yields maximum efficiency benefits.

9. In the area of *labor market and social safety nets*, our program comprises two main elements: improving the functioning of the labor market to facilitate economic restructuring; and strengthening the social safety net, both to mitigate the social costs of the current crisis and structural change and to make tangible, lasting improvements in Korea's system of social protection. We will fully implement the reform enacted in February this year legalizing layoffs, and will further enhance labor market flexibility by actions to reduce remaining market rigidities. Our labor market agenda also includes strengthening employment services and amending active labor market programs based on a critical review of their cost-effectiveness.

10. With the support of the World Bank, we have substantially strengthened our social safety net programs. With effect from October 1998, unemployment insurance will be extended to firms employing fewer than five workers and to temporary and part-time workers. Contribution rates will be adjusted to maintain the financial viability of the insurance scheme. For those not covered by unemployment insurance, we will expand the public works program and the means-tested non-contributory income support program for the unemployed poor. We are committed to expand in real terms budget allocations for poverty-targeted programs, such as the livelihood protection program, proportionately with any increase in the prevalence of poverty as a result of the crisis. We are also initiating a reform of our health insurance, to increase the protection of poor beneficiaries, improve the coverage of major financial risks, and raise administrative efficiency. Our continuing efforts in pension system reform focus on ensuring the adequacy of "social pension" for the elderly poor, and improving the transparency and efficiency of pension fund management and strengthening links to capital market development.

11. The Government will work closely with the Bank in implementing the reform program described above. To facilitate monitoring of progress on the reforms, we will provide the Bank relevant and timely information on the implementation of policies in all areas covered by the structural reform program and detailed in the Policy Matrix. On progress with corporate debt restructuring within the framework set out in the Policy Matrix, we will provide regular information in accordance with frequency and format agreed with the Bank. We will continue to provide periodic information on key indicators for the financial sector as agreed under the ERL. Also, we will provide information on selected indicators to help monitor the effects of policy reforms as agreed under the SAL, and on any additional such indicators proposed by the Bank.

12. We reaffirm our commitments made under the ERL and the SAL to halt directed lending and policy loans. We also reaffirm our commitments made under these loans with respect to the transparency of fiscal accounting.

13. In order to promote public awareness of our reform program, we will make full disclosure to the public of the program agreed with the World Bank, including making public the full text of this letter and its attached Policy Matrix and annexes.

14. In conclusion, Korea, under the leadership of President Kim Dae-Jung, remains fully committed to its reform program aimed at bringing about a major restructuring of its economy in order to restore strong and sustainable growth. The World Bank's continuing support to our program would be of invaluable help in enabling Korea meet the challenges of restructuring and achieve its growth and development objectives.

Signed

Kyu-Sung Lee
Minister of Finance and Economy

Attachment: Policy Matrix

KOREA: SECOND STRUCTURAL ADJUSTMENT LOAN
POLICY MATRIX

Macroeconomic Framework

Objectives	Policy Measures	
	First Tranche	Second Tranche
Restoration of financial stability and resumption of sustainable growth.	Sound management of macroeconomic policies—fiscal, monetary, exchange rate, and external debt and reserve management policies—conducive to financial stability and an early recovery of economic activity.	Continued adherence to a sound macroeconomic framework.

KOREA: SECOND STRUCTURAL ADJUSTMENT LOAN
POLICY MATRIX

Financial Sector Reform

Objectives	Policy Measures: First Tranche	Policy Measures: Second Tranche
Resolution of Weak Financial Institutions Develop financial sector restructuring strategy	Further develop and clarify strategy, in consultation with the Bank, including ensuring adequacy of public resources for use in recapitalizing and restructuring the financial system.	Continue to develop strategy (supported by TA). Issue written policies and guidelines consistent with that strategy (ongoing). In consultation with the Bank, adopt process and principles necessary to ensure adequate public resources will be made available by Government in financial system recapitalization and restructuring.
Resolve 5 undercapitalized commercial banks	FSC to agree specific contract terms with acquiring banks and communicate complete contract terms to Bank (August 31). Terms shall include: i) firm agreement on definition of amount and approach to non-performing assets subject to put-back taking into consideration non only past due status, but also qualitative factors affecting loss potential; ii) provision of enough time for acquiring banks to evaluate quality of acquired assets; iii) finality of contractual terms precluding subsequent renegotiation by acquiring banks.	Monitor implementation of contracts and performance (ongoing).
Resolve 7 undercapitalized commercial banks	Banks to submit implementation plans by July 31. FSC to distribute a template for review of implementation plans of the four largest conditionally approved banks to aid in evaluating the feasibility of banks' plans. (July 31). FSC to contract, under TORs agreed with Bank, with international experts to support in-depth analysis of the banks' implementation plans and any other submissions by banks related to the provision of government financial support (September 15). Adopt objectives and principles, acceptable to the Bank, to be used by Government in making decisions on banks' implementation plans, including provision of financial support by Government (August 31).	Announcement by FSC of its decision on implementation plans by September 30 (decision processes supported by domestic and international experts, chosen in consultation with the Bank). Banks whose implementation plans are not approved to be subject to direct recapitalization, mandatory mergers, transfer of business under P&A, or exit under PCA procedures. For banks which are subject to direct recapitalization by government, government will assume the responsibilities of ownership, including contracting with experienced senior managers to undertake restructuring, until sale to strategic investors with sufficient capital and expertise to manage banks. If a plan is approved, the bank will agree on an MOU with FSC covering, among others, recapitalization and merger plans, measures to manage and reduce non-performing assets, and timetable for achieving performance indicators (including capital adequacy targets). Dividend payments to be allowed only when performance indicators are met.

Objectives	Policy Measures	
	First Tranche	Second Tranche
		Banks whose approved plans are not, in the event, achieved will be subject to PCA.
Evaluate remaining commercial banks and take appropriate actions	Initiate diagnostic reviews of remaining commercial banks (on the basis of June 30 data) by internationally recognized accounting firms, signed by domestic and international partners (August 15).	If a commercial bank's capital ratio is found to be below 8% as of end-June 1998, FSC will proceed on a similar basis to that described above for 7 banks (September 30). If the capital ratio of a bank that had been above 8% subsequently falls below 8%, FSC will invoke PCA procedures. Based on the diagnostic review results, administrative guidance to strengthen banks' operations will be provided.
Complete privatization of Korea First Bank and Seoul Bank	Government to agree with the lead manager selected for privatization on the general deal structure (including confirmation to the Bank of the modalities of provision of public support), and to authorize lead manager to contact investors (September 15).	FSC/FSB will continue to conduct intensive supervision of these two banks, including in-depth analysis of management capacity, rehabilitation strategy, and financial condition (September 30). Obtain bids for sale of the banks to strategic investors with sufficient capital and expertise to manage banks (November 15); achieve progress, satisfactory to the Bank, toward sale.
Evaluate remaining merchant banks	FSC/FSB to strengthen supervision of existing merchant banks, including conducting on-site examinations to update assessment of financial condition, determine capital ratio integrity, and assess compliance with previously approved rehabilitation plans (August 31).	Implement strengthened supervision (ongoing). Banks falling short of minimal capital adequacy requirements or in substantial non-compliance with previously agreed rehabilitation plans, subject to resolution process.
Review specialized and development banks	Sign contracts for diagnostic reviews, including assessment of asset quality, with internationally recognized accounting firms, as for commercial banks (September).	Complete diagnostic reviews of at least the major specialized and development banks (December 15).
Use of public funds Adopt sound principles for the use of public funds in financial system restructuring and recapitalization	Government confirms that public funds will be used only: • in the context of: i) FSC-approved plans developed by banks for restructuring and recapitalization, whether as stand-alone entities or via acquisitions or mergers; ii) government takeover of undercapitalized banks; or iii) bank liquidation;	Firm adherence to these principles for the use of public funds (ongoing).

Objectives	Policy Measures	
	First Tranche	Second Tranche
	• with adequate burden sharing, including contribution of new capital by qualified investors and/or dilution of ownership interests of existing shareholders ; where acquisition of equity positions in government recapitalized banks will be through a transparent process and open bidding (exceptions to open bidding must have strong justification); • where the bank is making adequate progress on implementation of sound corporate debt restructuring; and • in the context of NBFI resolutions, to cover the difference between explicitly government-guaranteed liabilities and the market value of assets acquired by purchasers, or to payoff explicitly government-guaranteed liabilities in the case of liquidation. Any additional use of public funds for NBFIs will be limited to exceptional cases where failure of these institutions poses a systemic risk. Any such use of public funds would be made in the context of a comprehensive restructuring plan for the relevant NBFI sector.	
Resolve policy issues regarding asset management	Purchases by KAMCO will be at prices that reflect actual and expected recovery rates as well as the opportunity cost of the funds employed for collateralized loans, and nominal prices for unsecured loans (August 31).	Adoption by KAMCO of principles, acceptable to the Bank, for the disposition of troubled assets acquired by KAMCO, including the sale of a majority of assets within three years of acquisition. Adoption of procedures, sources and instruments of funding for KAMCO acceptable to the Bank (December 15).
Strengthen KAMCO's financial reporting and disclosure	Agree to publish complete semi-annual and annual audited financial statements (which include results of reviews of asset portfolio revaluations) prepared by an audit firm with international experience in asset revaluation (August 31).	Contract with audit firm, with the first audit to be conducted on June 30, 1999 financial statement (December 15).

Objectives	Policy Measures	
	First Tranche	Second Tranche
Strengthen KAMCO's infrastructure	Hire qualified experts to assist in the design and implementation of the organizational and operational structure based on TORs acceptable to the Bank (August 31). Contract with data management (MIS) firm with proven track record, according to TORs agreed with the Bank, for installation of asset inventory and management information systems (August 31).	Complete design and agree to implement recommended actions (December 15). Installation of system in process (ongoing). Contract with at least one international asset management company to manage and sell assets, according to TORs agreed with the Bank (October 31), and have the asset management company in place (December 15).
Strengthen Supervision and Regulation Strengthen independence and authority of supervisory agencies	Prepare three-year FSB operating budget. Allocate adequate, separate funds for FSB startup costs, and initial operating and extraordinary expenses (including costs of procuring information technology, and TA needs).	Consistent with the Basle Committee's 25 Core Principles for Effective Banking Supervision, enhance independence of FSC/FSB through ensuring operational independence and adequate resources. Issuance and revocation of financial institutions' licenses to be carried out upon recommendation of FSC. Review the adequacy and effectiveness of FSC's governance structure and organization, including the need for greater representation of members nominated by independent associations as the current FSC members' terms expire. Establish the legal framework through which FSB may assess fees on supervised institutions, with revenues specifically dedicated to the operations of FSB. Evaluate funding needs and establish FSB's internal budgetary and funding systems (December 15). Complete unification of supervisory organizations. Enhance consolidated supervision and extend supervisory arrangements for commercial banks to all NBFIs as appropriate (December).
Institutionally strengthen FSC	Request proposal for contract with internationally recognized consultant firm, according to TORs agreed with Bank, to implement the strategic blueprint for FSC/FSB institution building, supervisory consolidation, information technology, upgrade of human resources, and strengthening of supervisory policies and processes (August 31). FSC/FSB to establish and operationalize a special implementation task force fully dedicated to the tasks of agency consolidation and strengthening of supervision and human resources. Task force to report to Chairman of FSC and empowered to access personnel in each of the 4 supervisory agencies (August 31).	Establish management group within FSB and implement enhanced managerial structure (December 15). Implement other major elements of strategic blueprint, including information systems, policies, operational procedures, human resources, and budgetary/administrative functions. Contract signed with internationally recognized consultant firm (September 30) and major elements implemented (December 15).

Objectives	Policy Measures	
	First Tranche	Second Tranche
Enhance supervision	With respect to specialized and development banks, delegate to FSC powers to examine and to make recommendations as to consequential remedial actions for these institutions (August 31).	On the basis of examinations of specialized and development banks at the delegation of MOFE, FSC will make recommendations to MOFE as to any consequential remedial action required (ongoing). FSB to strengthen supervisory policies, processes and procedures for all subject financial institutions, including on-site supervision, off-site surveillance, monitoring, and enforcement.
Upgrade regulation	Issue implementation plan to bring Korea's prudential regulations closer to international practice as expressed in Basle Committee's 25 Core Principles for Effective Bank Supervision (August 15). Plan will cover rules relating to capital definition, loan classification, disclosure of trust accounts, segregation of trust accounts and treatment of trust accounts with guarantees as on-balance sheet items. Submit legislation to amend the Act Concerning the Structural Improvement of the Financial Industry, inter alia, to redefine a "distressed" financial institution so as to allow imposition of sanctions before actual insolvency and to permit the full write down of shareholder equity (August 31).	Issue regulations to extend, effective January 1, 1999, prudential rules applied to commercial banks to specialized and development banks taking into account the special characteristics of the institutions (November 15). Extend connected lending regulations that apply to commercial banks to merchant banks. Adopt timetable for reductions in connected lending limits; connected lending audited and disclosed in annual financial statements (effective January 1, 1999). Submit to National Assembly amendments to General Banking Act, and similar act for merchant banks, to lower single borrower and group exposure limits over time (October 31).
Improve troubled debt restructuring		Issue guidelines by FSC for troubled debt restructuring and workout processes in banks, including best practice regulations regarding treatment of Other Assets Owned (including maximum holding periods, yearly valuations, validation by third-parties, and write-downs, if necessary), workout policies, and asset management plans (October).
Rationalize deposit insurance		Rationalize deposit insurance scheme, including through phasing out of general guarantee (ongoing).
Capital Market Development Enhance functioning and competitiveness of securities markets	Strengthen prudential rules for securities markets' activities of all financial institutions, including strengthening standards for internal risk management, adoption of appropriate timetable for moving to mark-to-market accounting for all financial institutions, and use of credit rating (August). Develop implementation plans, with timetable to: i) promote self-regulation, including through delegation of	Submit to National Assembly necessary changes in Securities and Exchange Law to enhance the role of SROs (December 15).

Objectives	Policy Measures	
	First Tranche	Second Tranche
	increased regulatory and supervisory authority to self-regulatory organizations (e.g., KSE, KSDA, KITCA); and ii) reform governance structure of these SROs with the aim to promote their commercial sensitivity and independence (September 15). Develop implementation plan to liberalize trading systems, including allowing for proprietary trading systems, and to strengthen clearing and settlement systems (September 15).	Announce key elements of action plans and achieve progress in implementation (December 15).
Develop bond markets	As outcome of existing task force, create institutional setup to formulate an action plan, with timetable, to develop bond markets (primary and secondary), including: development of a (rolling) three-year plan for central government financing (including funding costs associated with financial restructuring), standardization of new government and government agencies' funding instruments, and consolidation of existing instruments (August).	Announce key elements of action plan with appropriate timetable to develop the bond market, including standardization of new funding instruments and replacement of government-guaranteed bonds with sovereign bonds (December 15). Institutionally strengthen Treasury-functions (December 15). Introduce a framework to develop market-makers network, including adoption of minimum rules and time-table to select primary dealers in government bonds, and authorize banks to act as market-markers in government bonds (December 15).
Develop public asset-liability system	Initiate external debt management component of a comprehensive, integrated external and internal public asset-liability management system (ALM), supported by Bank TA-loan (August).	Implement actions of agreed program on external debt management component and complete report detailing actions with timetable to extend ALM to internal debt and contingent liability components (December 15).
Develop institutional investors	Submit Securities Investment Company Act to allow, among others, the establishment of mutual funds (August). Submit legislation to allow asset-backed securities (August).	

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Supplement to Policy Matrix on Financial Sector Reform

As part of the Policy Matrix on Financial Sector Reform, the Government is to adopt objectives and principles acceptable to the Bank to be used by the Government in making decisions on the implementation plans of the seven undercapitalized banks, and other banks so identified, including the provision of financial support by the Government. The Government has adopted the following objectives and principles:

Objectives:

- Bring in new private investors with substantial capital at risk, and who are fit and proper and will exert a positive, professional influence on bank governance.
- Bring in new managers with proven technical and managerial skills and experience to operate and restructure banks of comparable size.
- After receiving support, banks are adequately capitalized, have adequate liquidity and are sustainably profitable.
- Banks undergo operational restructuring in a minimum period of time, rapidly implement world-class risk management practices, and resume normal banking activities (e.g., lending to creditworthy firms).
- Government financial assistance to banks provided only where demonstrably less costly to the Government than liquidation.
- Government recovers to maximum extent possible its financial assistance.
- Government sells its ownership interest within shortest period possible.

Principles:

- Provision of financial support to banks by government may include equity capital contributions in the form of cash or interest-paying financial instruments, purchase of loans, purchase of subordinated debt, and/or guarantees on bank assets.
- Government will make transparent the criteria and processes for providing financial support.
- Government will attempt to attract new capital from qualified investors wherever possible, using the provision of financial support as an inducement to new investment where required.
- Government support will be conditional upon approved restructuring ("self-rescue") plans and efforts by banks.
- Government will make transparent its exit strategy, including publicly announcing its commitment to sell its ownership interests as soon as possible.
- Financial support (including direct recapitalization) will be provided only after capital has been adjusted to reflect its true value, taking into account adequate estimates of losses in currently identified non-performing assets (NPAs), as well as losses associated with a further deterioration in loan quality.
- Existing shareholders of undercapitalized banks will suffer a significant dilution of their ownership interests.
- In the case of mergers among undercapitalized banks, the government will provide financial support in an amount necessary to increase resulting bank capital to 10% of risk-adjusted assets based on Basle Committee risk-weighting criteria, and will obtain a substantial interest in the bank (generally 80 or 90% or more).
- In the case of mergers among an adequately capitalized bank and an undercapitalized bank, the government will provide financial support in an amount necessary to increase resulting bank capital to the level of the adequately capitalized bank, which will in all cases exceed 8% of risk-adjusted assets based on Basle Committee risk-weighting criteria.
- In the case of an acquisition by an adequately capitalized bank of an undercapitalized bank subject to mandatory transfer (e.g., P&A transactions), the government will provide financial support in an

amount necessary to increase resulting bank capital to the level of the adequately capitalized bank, which will in all cases exceed 8% of risk-adjusted assets based on Basle Committee risk-weighting criteria.

- In cases other than mergers and acquisitions as set out above, as an inducement to new equity capital investment the government will provide financial support in the form of equity capital in an amount equal to equity capital contributed by new investors, in order to increase capital to 8% of risk-adjusted assets based on Basle Committee risk-weighting criteria.
- In the case of an undercapitalized stand-alone bank where no new third-party investment is involved but the bank is engaged in an adequate, FSC-approved self-rescue effort, the government may provide financial support in a form other than contribution of equity capital.
- In cases other than those set out above, the government will directly recapitalize undercapitalized banks where an analysis is performed demonstrating that liquidation is not a less costly option to government.

KOREA: SECOND STRUCTURAL ADJUSTMENT LOAN
POLICY MATRIX
Corporate Sector Reform
Part A: Corporate Financial Restructuring

Objectives	Policy Measures	
	First Tranche	**Second Tranche**
1. Develop framework and capacity to do voluntary corporate workouts		
(a) Provide an overall framework of principles and procedures.	FSC provides guidelines on the following: - selection of corporate restructuring candidates; - a Corporate Restructuring Agreement ("Agreement") to provide a structure for creditor/debtor negotiations; - creation and operation of a Corporate Restructuring Coordination Committee ("Coordination Committee") to resolve inter-creditor disputes; and - "London rules" type principles to guide voluntary corporate workouts (July). FSC to monitor workouts under Agreement to ensure consistency with the issued guidelines for workouts (August).	Continued monitoring of the implementation of the framework and guidelines.
(b) Assign responsibility for leading voluntary corporate workouts.	FSC identifies Lead Banks (July).	
(c) Gain creditor support for approach to voluntary corporate workouts.	FSC obtains adherence of major creditors to Corporate Restructuring Agreement (July).	
(d) Provide necessary professional resources for Lead Banks.	Lead Banks to establish workout units (July). Lead Banks to retain internationally accredited advisors by September 15.	
(e) Provide means to resolve inter-creditor disputes.	Facilitated by FSC, banks to establish a Coordination Committee (July). Coordination Committee to hire staff by August 15 and, as necessary, retain internationally accredited advisors.	
2. Provide policy support for corporate restructuring		
a) Curtail emergency loans	While financial institutions may provide new or additional loans to distressed but viable corporates as part of a Corporate Restructuring Agreement workout, FSC will provide guidelines for such lending by August 15. These guidelines would include the following:	Monitor observance of the guidelines

Objectives	Policy Measures	
	First Tranche	**Second Tranche**
	- GOK will refrain from directing the banks to make such loans; - the size of any loan would normally be limited to the shortfall needed to meet interest expense and trade payables during the "standstill" period; - in return, the debtor would facilitate complete access by the Lead Bank's financial advisors (e.g., auditors) to the debtor's records; - during the standstill period, the Lead Bank's financial advisors would assess the debtor's viability, review the debtor's liabilities and cash flow projections, and – as appropriate – value assets and indicate how best to maximize the return to creditors – i.e., through voluntary workout, composition, reorganization, or liquidation. In exceptional cases, debtors due to be restructured, but not currently in the workout process, will require new loans. In such cases, if the banks are agreeable to providing such loans they will be provided per the guidelines noted above and for a maximum initial period of six months.	
(b) Facilitate use of debt/equity conversions to address excessive leverage among *chaebol* affiliates.	GOK will review if there are any tax disincentives and regulatory impediments to the conversion of corporate debt into equity or near equity and will submit legislation to National Assembly as necessary (September 15). GOK will submit legislation to National Assembly on mutual funds (August 30). FSC will meet with experienced asset managers, corporate turnaround experts, and investors in distressed securities from the private sector to assess options for "corporate restructuring vehicles" (CRVs). Privately financed and managed, CRVs would purchase and/or manage corporate equity acquired by financial institutions as a result of debt/equity conversions. Key issues for FSC to discuss with potential CRV managers would include appropriate business forms for CRVs (e.g., partnerships, blind trusts, stock funds) and potential tax, legal, and regulatory issues (August).	

Objectives	Policy Measures	
	First Tranche	Second Tranche
	GOK will identify legal, tax, and regulatory impediments – if any – to the establishment of CRVs (September 15).	Based on this review, and if necessary, GOK will submit legislation to the National Assembly enabling and regulating the formation of CRVs and removing tax, legal, and regulatory impediments to CRV formation and operation (December 15).
(c) Reduce cross guarantees.	FSC will encourage creditors to reduce cross guarantees through voluntary workouts conducted under the Corporate Restructuring Agreement (August). FSC will issue a communication to banks suggesting market-based approaches for "buying out" cross guarantees. These approaches could include, for example, conversion of cross guarantees into guarantor's equity or equity warrants or into a non-guaranteed loan at a higher interest rate (August). FSC will require financial institutions to report on the stock of guaranteed loans to the 64 *chaebol* as of June 30, 1998, by September 15; and, starting with the fourth quarter of 1998, FSC will require quarterly progress reports from banks on progress in reducing cross guarantees for the 64 *chaebol* (August 15).	Ongoing FSC will establish appropriate internal interim benchmarks to monitor progress toward the reduction of cross guarantees (October).
(d) Provide additional encouragement for corporate mergers and acquisitions, debt restructuring, and asset dispositions as means of corporate restructuring.	GOK to submit to National Assembly proposed package of tax measures to encourage corporate M&As, asset sales and debt restructuring (September 15).	GOK will submit additional legislation to National Assembly removing tax disincentives to corporate M&As, asset disposals, and debt restructuring (December 15).
(e) Improve procedures and coordination for court-supervised insolvency.	GOK will establish a Task Force under TORs acceptable to the Bank to review existing insolvency laws for further improvement, focusing on expedited procedures (e.g., pre-packaged bankruptcies resulting from the workout process) (September 15). FSC and MOJ, subject to agreement with the Supreme Court, will establish a liaison committee comprising these three entities to ensure prompt resolution of issues that affect both voluntary restructuring and court-supervised insolvency (September 15).	MOJ will agree to announce, based on the review, its draft amendments to existing insolvency laws designed to promote expedited insolvency procedures for public hearing and subsequent submission to the National Assembly by February 1999 (December 15).

Objectives	Policy Measures	
	First Tranche	Second Tranche
3. Accelerate implementation of corporate restructuring		
(a) Complete "triage" analysis.	Lead Banks will complete their assessment of *chaebol* affiliates (including those from the top 5) that have received "anti-bankruptcy" loans or which are on bank "watch" lists and will indicate whether each is best suited for court supervision, voluntary workout under the Corporate Restructuring Agreement, or normal operation (July).	Monitor follow-up.
	A special Task Force has been convened amongst four of the Lead Banks to focus on a system for monitoring the top five *chaebol*. The Task Force will also examine the workout programs of the top five *chaebol*. The Task Force will complete its assessment by end-September.	Monitor follow-up.
(b) Pursue inter-creditor agreements, under the Business Restructuring Agreement, on corporates to be restructured.	First Creditors Council meetings will be convened by each of the Lead Banks under terms of the Agreement (July/August).	Ongoing
	FSC will direct each Lead Bank to provide monthly reports on the status of corporate workouts (September 15).	Ongoing
		FSC will direct the Coordination Committee to provide monthly reports to FSC on inter-creditor disputes and their resolution (October).
(c) Pursue a timely exit strategy for the 55 non-viable corporates.	FSC will direct Lead Banks to stop new lending and withdraw existing loans for each of the 55 (July).	Lead Banks to provide monthly reports to FSC on progress in exiting the 55.
(d) Identify additional non-viable corporates.	FSC will require monthly updates from Lead Banks on additional corporates identified as non-viable during the course of Corporate Restructuring Agreement workouts (August).	Ongoing
(e) Initiate resolution of corporates that are not under court supervision, but which have received emergency loans.	FSC will direct Lead Banks to send auditors into *chaebol* affiliates that have received emergency loans – but which are not operating under court supervision – and give the auditors 60 days to review corporate liabilities, cash flow projections, and asset values, assess viability, and indicate how to maximize the return to creditors – e.g., through voluntary workout, composition, reorganization, or bankruptcy (August).	Monitor follow-up.

Objectives	Policy Measures	
	First Tranche	**Second Tranche**
(f) Expedite resolution of corporates under court supervision in which the GOK is a major shareholder.	KDB will invite international bids under transparent and fair procedures for Kia (July). KFB will invite such bids for Hanbo by September.	Monitor next steps.
(g) Develop an ability to anticipate corporate default or insolvency.	FSC will establish a "situation room" to monitor corporate/financial sector solvency (July).	
(h) Promote self-restructuring by the top 5 *chaebol*.	FSC will provide guidelines to Lead Banks to strengthen the "capital structure improvement plans" of the top 5 *chaebol*, including decreases in debt/equity ratios, disposal of non-viable affiliates, and reductions in cross guarantees (July). Fair Trade Commission will monitor and take actions against the top 5 *chaebol* that engage in anti-competitive intra-group transactions (July).	Monitor implementation of the guidelines. Continued monitoring and enforcement.

Note: Unless otherwise indicated, actions related to the first tranche release will have been implemented before presentation of the loan to the Executive Directors and actions related to the second tranche release will have been implemented before the release of the second tranche.

KOREA: SECOND STRUCTURAL ADJUSTMENT LOAN
POLICY MATRIX
Corporate Sector Reform
Part B: Corporate Governance, Competition Policies, and Reform and Privatization of SOEs

Objectives	Policy Measures	
	First Tranche	**Second Tranche**
<u>Corporate Governance</u> (a) *Corporate Boards and Shareholder Rights*		
Promote effective monitoring of corporate performance.	Submit to National Assembly changes to the Commercial Code to impose on directors and "shadow" directors a duty to act in the interests of the company .	Enact the changes to the Commercial Code.
	Require listed companies to have a minimum of 25% of their boards comprised of outside directors.	
	Submit to National Assembly legislation to further reduce the thresholds for exercise of minority shareholder rights.	Enact the legislation.
	Establish a study team to provide a report and recommendations to Government on the introduction of class action law suits.	Completion of the report and submission of its recommendations to Government on the introduction of class action law suits.
	Establish a study team to provide a report and recommendations to Government on the role and functions of boards of directors.	Complete the report, draft legislation to give effect to its recommendations, and announce a timetable acceptable to the Bank for submission to National Assembly.
	Remove restrictions on the voting rights of institutional investors in listed companies.	
(b) *Legal Framework for Creditors' Rights*		
Improve the insolvency system and strengthen capacity to handle bankruptcy cases.	Creation of bankruptcy commission to assist Seoul District Court by handling aspects of insolvency litigation.	
	Appoint a task force comprising representatives of the judiciary and MOJ under TORs acceptable to the Bank to study the speedy adjudication of bankruptcy cases, including the establishment of one or more specialist bankruptcy courts.	Establish a pilot specialist bankruptcy court in Seoul with dedicated judges.

Objectives	Policy Measures	
	First Tranche	Second Tranche
Facilitate lending to SMEs through improved tools for secured lending.		Establish a Task Force to design a modern system for secured lending on movables and a national registry system. The Task Force to complete its work and make its recommendations by December 15.
(c) *Financial Transparency and Accountability*		
Rationalize the institutional framework for setting standards, regulating and overseeing the accounting and auditing profession.	Establish a Task Force under TORs acceptable to the Bank to review and recommend revisions to relevant laws and regulations to: rationalize the role of various government agencies in supervising the accounting and auditing profession; strengthen the role of KICPA as a self-regulating body consistent with international best practice; and develop an implementation plan for establishing an independent accounting standard setting organization. Commitment to establish an independent accounting standard setting organization by June 1999.	Complete the review and remove all directives affecting accounting and auditing standards and practices by various government agencies including the Bank Supervisory Board and Insurance Supervisory Board and consolidate appropriate regulatory responsibility in the Securities Supervisory Board. Adopt and announce an implementation plan acceptable to the Bank for the establishment of an independent accounting standard setting organization by June 1999. Submit to National Assembly amendments to applicable laws and regulations to give effect to the recommendations of the Task Force, including changes in CPA Law, External Audit Law, and Securities and Exchange Law.
Strengthen KICPA and make it independent of government and the primary source of guidance in auditing.	Establish a Task Force under TORs acceptable to Bank to: review and strengthen KICPA's charter, operational structure and capacity; assess the appropriateness of rules and regulations on auditing including maximum audit fee, numerical restrictions based on CPA head count, minimum audit contract period, evaluation of audit firms by government, and allocation of audit clients by government; and strengthen KICPA's role in issuing auditing standards, monitoring professional quality, enhancing professional ethics and enforcing the code of conduct.	Complete the review and adopt a time-bound implementation plan satisfactory to the Bank. Begin implementation of recommended changes in rules and regulations. Submit to National Assembly amendments to applicable laws.
Upgrade accounting and auditing standards to make them consistent with international best practice, requiring that financial statements of companies and financial institutions be prepared in accordance with these improved standards with effect from the 1999 reporting year, as agreed under SAL I.		Adoption and issuance by FSC of improved accounting and auditing standards for financial institutions, listed companies and joint stock companies consistent with international best practice and prepared with participation of representatives of internationally recognized accounting firms, and institution and announcement of the requirement that financial statements of financial institutions, listed companies, and joint stock companies with assets in excess of W7 billion will be prepared and audited in accordance with these standards from fiscal year 1999. The improved accounting standards will

Objectives	Policy Measures	
	First Tranche	Second Tranche
		include, inter alia, standards covering financial instruments, leases, asset classification, troubled debt restructuring, asset revaluation, translation of foreign currencies, loss and income recognition, financial statement disclosure, and combined financial statements.
Improve the financial oversight role of boards of directors and enhance the effectiveness of the internal audit function.	Complete the study on introduction of audit committees of boards of directors and improvement of the effectiveness of the internal audit function for listed companies and financial institutions under TORs acceptable to the Bank, as agreed under SAL I.	
	Appoint a Task Force under TORs agreed with the Bank to: review and rationalize the function of the audit selection committee to make it an independent and transparent entity and develop an implementation plan to upgrade it to an audit committee of boards of directors, taking into account the conclusions of the above study; and recommend changes in relevant laws and regulations.	Completion of the review. Adoption and announcement of an implementation plan and schedule acceptable to the Bank for the institution of a requirement for the establishment by listed companies of audit committees of boards of directors, and completion of a draft of necessary changes in laws and regulations to give effect to this requirement.
Improve the quality and frequency of financial reporting by listed companies.		Require listed companies to publish quarterly financial statements with adequate disclosure consistent with international best practice starting in 2000 Q1.
<u>Competition Policies</u> Increase competition across all sectors.	Complete draft of amendments to Fair Trade Act (FTA), acceptable to the Bank, based on recommendations of the Joint Public/Private Sector Committee.	Enact the amendments.
	Commitment to fully enforce provisions of the FTA in the restructuring of chaebols in accordance with the policy statement issued under SAL I.	KFTC to provide the Bank with a detailed report and analysis of all cases of chaebol M&A, divestiture and restructuring notified and considered prior to the second tranche release, in a format agreed with the Bank.
		Enact the Act on Comprehensive Regulation of Cartels.
		Review and propose revisions as required to the GOK procurement guidelines to assure transparency, and limit opportunities for collusion and corruption.
	Issue and implement comprehensive M&A guidelines.	Monitor compliance, especially in chaebol restructuring.

Objectives	Policy Measures	
	First Tranche	Second Tranche
Strengthen the enforcement of rules limiting transactions between related corporations, companies, financial institutions, their owners, directors, shareholders and employees.		Apply existing laws stringently and uniformly, and propose amendments to the FTA to further limit such transactions.
Establish a more transparent framework for corporate group rights and obligations.		Enact legislation, satisfactory to the Bank, modifying restrictions under the FTA on the creation of holding company structures so as to permit such structures subject to conditions to avoid undue ownership concentration.
Strengthen the operational capacity of KFTC.	Implement the agreed work plan for the Policy Analysis and Evaluation Group.	Develop detailed KFTC operational guidelines (e.g., investigative guidelines) and achieve satisfactory progress in implementing an appropriate upgrading program.
Further deregulate domestic industry to promote competition.	Complete submissions to the Deregulation Committee on regulatory barriers in different industries.	Achieve satisfactory progress in implementing necessary legislative or regulatory changes.
Promote foreign direct investment.	Enact the Foreign Investment Promotion Act.	Implement the new Act (simplification of procedures, improved support system).
Support competition in domestic industry by easing import requirements and administration.	Review customs clearance and product certification/registration procedures and develop a plan to streamline them.	Achieve satisfactory progress in implementing the streamlining plan.
Reform and Privatization of SOEs (a) *SOE Restructuring and Governance Reforms*		
Ensure that SOEs that are to remain under state control or are to be privatized gradually, operate in an efficient and accountable manner.	Review the Basic Law on Management of "State-Capitalized" Enterprises in order to improve management structure of such SOEs, including the allocation of policy, regulatory and ownership functions.	Submit to National Assembly legislation to improve the management structure of SOEs.
(b) *General Privatization Program*		
Ensure that the Government's proposed privatization and SOE reform program is implemented within a sound framework.	Announce a program of privatization, including identification of SOEs to be offered for sale, extent of proposed share or asset sales and, as appropriate, proposed	Submit any necessary privatization legislation, including amendments to the privatization law, to National Assembly.

Objectives	Policy Measures	
	First Tranche	Second Tranche
	methods and target schedule for the completion of such proposed sales. Establish a steering committee, supported by task forces, to oversee implementation of the privatization program. Review need for any enabling legislation.	
(c) *Infrastructure Sectors*		
Improve regulatory and institutional framework for increased private participation in the provision of infrastructure services.	Adopt and announce an overall strategy acceptable to the Bank for dealing with structural, regulatory and institutional issues in privatization and SOE reform in infrastructure sectors, including, inter alia, the priority to be given to transition toward more competitive market structures and establishment of appropriate regulatory structures, and sequencing of structural, regulatory and ownership reforms.	Satisfactory progress in implementing the privatization and SOE reform program in infrastructure sectors in accordance with the principles included in the strategy statement.
	Undertake a study on reforms to the regulatory and institutional framework for involving private participants in greenfield infrastructure projects.	Announce key elements of proposed reforms.
Telecommunications	Undertake a study on reforms to pricing, interconnection and universal service arrangements, and the establishment of an independent regulatory authority.	Announce key elements of proposed reforms, including timetable for implementing those reforms, prior to any further privatization of KT and, in any case, before December 15.
Power	Undertake a study on structural and regulatory reforms in the power sector, including the establishment of an independent regulatory authority.	Announce key elements of proposed structural and regulatory reforms, including timetable for implementing those reforms.
Gas	Undertake a study on structural and regulatory reforms in the gas sector, including the establishment of an independent regulatory authority.	Announce preliminary findings of the study by December 15. Announce key elements of proposed structural and regulatory reforms, including timetable for implementing those reforms, before proceeding with the privatization of KOGAS.

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KOREA: SECOND STRUCTURAL ADJUSTMENT LOAN
POLICY MATRIX
Labor Market and Social Safety Nets

Objectives	Policy Measures	
	First Tranche	**Second Tranche**
Integration of Social Policy Reform Agenda Improve the framework for the design and coordination of social safety net policies.	Commitment to clearly mandate and adequately staff the National Committee on Social Security chaired by the Prime Minister, to coordinate cross-cutting reforms in social policies in order to achieve coherence across concerned ministries and agencies.	Establishment of a Working-Level Committee under the National Committee on Social Security, anchored in the Prime Minister's Office and provided with adequate professional staff capacity, to serve as a focal point. Complete interim assessment report on cost-effectiveness of integrating contributions to social risk management funds for pensions, medical insurance and unemployment insurance, including: (a) collection mechanisms; (b) contribution base determination; and (c) cross-checking features. Complete interim assessment report on the aggregate payroll tax and labor market implications of adjustments in coverage and contribution rates for pensions, medical insurance and unemployment insurance.
Social Protection for Workers Expand sustainable coverage of income support provided by the unemployment insurance (UI) component of the Employment Insurance Scheme (EIS).	Extend UI to firms with fewer than 5 workers and to temporary and part-time workers with effect from October 1998. Commitment to maintain actuarial integrity of the UI scheme, i.e. positive financial reserves, and zero leakage to other programs (per SAL I agreement).	Adjust contribution rates if necessary in order to maintain financial viability of UI scheme for FY99 given anticipated unemployment rate and any changes in benefit structure (per SAL I agreement).
Increase employment by enhancing labor market flexibility.	Commitment to implement fully the layoff provisions of the 1998 Labor Standards Act so as to remove undue labor market impediments to efficient corporate restructuring.	Achievement of progress, satisfactory to the Bank, on enhancement of labor market flexibility. Complete report providing recommendations for appropriate expansion of public employment services without crowding out private employment services.

Objectives	Policy Measures	
	First Tranche	Second Tranche
Improve efficiency of active labor market programs by eliminating cost-ineffective programs provided under the employment security (ES) and vocational ability development (VAD) components of EIS.	Commitment to limit expenditure on ES and VAD programs by containing contribution rates at or below current levels (0.3% for ES and averaging 0.4% for VAD) and maintaining positive financial reserves. Commitment not to provide budget subsidies that increase the scope of ES and VAD activities beyond self-financed operations. Commitment not to expand coverage of ES and VAD programs any further. Finalize TOR acceptable to the Bank and initiate formal evaluation of cost-effectiveness of ES and VAD programs	Complete interim evaluation report on the cost-effectiveness of ES and VAD programs (per SAL I agreement). Hold national workshop with stakeholders to discuss the interim evaluation report. Disseminate the interim evaluation report. Announce policy adjustments to eliminate ES and VAD programs found to be cost-ineffective
<u>Protecting the Poor</u> Expand provision of workfare for the unemployed who are not insured.	Implement expanded Phase II of the temporary public works program at wage levels designed to target the poor jobless by self-selection. Restrict participation to the unemployed who are not currently eligible to receive UI benefits.	Allocate adequate FY99 budget to absorb supply of labor forthcoming for public works at targeted wage levels (not higher than Phase II in real terms). Relax capacity constraints on workfare expansion by involving NGO and private sector contractors.
Expand provision of means-tested noncontributory income support for the poor.	Commitment to expand budget allocation in FY99 to the temporary noncontributory means-tested allowance for the unemployed poor in line with increases in the eligible target group. Commitment to expand budget allocation in FY99 to workfare and other forms of income support for able-bodied beneficiaries of "self-support" under the livelihood protection program for the poor.	Allocate adequate FY99 budget. Allocate adequate FY99 budget.
Maintain real expenditure per eligible beneficiary on existing livelihood protection programs for the poor (self-support, home care and institutional care programs).	Initiate analytical report assessing trends in the 1998 inflation rate adjusted for consumption patterns of poor households. Initiate analytical report assessing 1998 trends in the number and characteristics of people living in poor households.	Complete the two reports by October 30. Allocate adequate FY99 budget taking into account: (a) adjustment of nominal per capita benefits to compensate for inflation among the poor; and (b) adjustment of total budget to absorb increased number of eligible poor.

Objectives	Policy Measures	
	First Tranche	Second Tranche
Strengthen information base for regular poverty monitoring and analysis.	Implement special National Survey of Employment Assistance and Welfare Needs of the Unemployed (KIHASA/KLI/NSO collaboration). Assign institutional responsibility for coordinating interagency inputs to design of an integrated multipurpose national household survey.	Hold national workshop to review design options for a regular national multipurpose household survey, including a panel subsample, incorporating comprehensive data on household welfare and coverage of government programs. Complete feasibility report for introducing a regular national multipurpose household survey, including questionnaire design, sample size, field operations, policy analysis and institutional responsibilities.
<u>Financial Risk Management for Health</u> Improve efficiency of financial intermediation by public sector health insurers through reducing the unit costs of administration per insured under the national Medical Insurance System (MIS).	Complete prospective assessment report on cost-effectiveness of alternative options for consolidation of the fragmented insurance societies belonging to Self-Employed Medical Insurance (SEMI) component of MIS. Commitment to incorporate the financial operations of MIS into the consolidated fiscal accounting framework of the published Government Finance Statistics for the public sector, beginning with FY99 fiscal accounts.	Implement consolidation plan for insurance societies under SEMI.
Strengthen supply-side incentives for efficient provision of medical care.	Commitment to implement a universal reform of the provider payment system to improve cost containment incentives based on DRG-based pricing.	In consultation with the Bank, announce a detailed timetable for implementation of the provider payment reform plan beginning with the year 2000.
Improve demand-side protection against major financial risks for MIS beneficiaries and for poor Medicaid beneficiaries by reducing out-of-pocket copayments.	Commitment to significantly reduce by FY2000 the effective coinsurance rate for hospital inpatient care, combined with an income-related catastrophic cap, both for MIS and Medicaid. Initiate preparation of a coinsurance reform plan, both for MIS and Medicaid, including adjustments to special treatment changes, inclusion of noncovered services, and reallocation of health insurance coverage from minor to major risks.	Adopt and announce key elements of the coinsurance reform plan, both for MIS and Medicaid, including the timetable for implementation beginning with FY2000.

Objectives	Policy Measures	
	First Tranche	Second Tranche
	Commitment to harmonize Medicaid provider reimbursement levels with MIS. Implement an official investigation of leakages of allocated budget funds from reaching poor beneficiaries of the Medicaid program.	Commitment to allocate adequate FY2000 budget to implement provider reimbursement reform for Medicaid beneficiaries. Complete investigation report and initiate implementation of its recommendations.
Diversify policy instruments for pooling financial risks of medical care.	In consultation with the Bank, finalize TORs and initiate evaluation report on introduction of individual medical savings accounts (MSAs) to finance intermediate financial risks associated with medical care.	Hold public workshop to review findings and recommendations of assessment report on introduction of MSAs.
<u>Social Protection for the Elderly</u> Mitigate impact of the economic crisis on living standards of the elderly.	Initiate analytical report assessing the effectiveness of the means-tested noncontributory "social pension" for elderly aged over 65 in terms of coverage of the target group, and prevention of poverty among recipients.	Complete the analytical report and allocate adequate FY99 budget for the social pension to achieve effective coverage of the poor elderly target group.
Improve transparency and governance of financial operations of all public pension schemes (NPS and occupational schemes for civil servants, teachers and military).	Commitment to establish an Office or function of the Actuary in the Office of the Prime Minister responsible for annual projections of the long-term actuarial status of all public pension schemes based on consistent macroeconomic and demographic assumptions. Commitment to incorporate the financial operations of the Teachers and Civil Servants pension schemes into the consolidated fiscal accounting framework of the published Government Finance Statistics for the public sector, beginning with FY99 fiscal accounts.	Establish the Office/function of the Actuary. Allocate adequate FY99 budget to prepare and publish the first annual status report for FY98.
Develop an integrated pension reform proposal that fully recognizes and rationalizes the mandatory public and private components of the existing pension system.	Finalize TORs acceptable to the Bank governing the structure, composition and mandate of the Government Task Force responsible for the planned comprehensive White Paper on Pension Reform (per SAL I agreement).	Establish the Government Task Force by October 1998 (per SAL I agreement). Commitment to complete draft White Paper no later than November 1999 (with background papers completed by June 1999) on an integrated pension reform package combining public/private and mandatory/voluntary pensions pillars designed to attain: (a) a reasonable replacement rate target for the average worker;

Objectives	Policy Measures	
	First Tranche	Second Tranche
		(b) reasonable protection from poverty for the aged; and (c) long-term financial sustainability. Completion of progress report on the work program of the Task Force.
Achieve more efficient allocation of National Pension Fund (NPF) assets.	Adopt and announce a timetable for implementation of the reduction in forced government appropriation of the flow of NPF surpluses (per SAL I agreement) as follows: 65% of the NPF surplus flow in 1999, 40% in 2000, 20% in 2001 and 0% in 2002. Announce that the stock of outstanding loans to government from NPF will be repaid in full at maturity without rollovers.	Implement the phased reduction of forced government appropriations from NPF agreed with the Bank, through adoption of legislation satisfactory to the Bank, including necessary revisions to the Public Fund Management Act. Implement plan to strengthen the professional investment unit in the National Pension Corporation (per SAL I agreement), including: (a) achievement of a high standard of staff qualifications and supporting technology; and (b) adequate resources to monitor external fund managers.
	In consultation with the Bank, announce specific guidelines for governance of NPF reserves, including: (a) the task of the asset management committee; (b) investment rules and rating procedures; (c) benchmarking and reporting mechanism; and (d) index-based criteria for selecting external fund managers.	Announce a schedule acceptable to the Bank for contracting out asset management and implement plan to increase gradually and substantially the share of NPS assets outsourced to external fund managers (per SAL I agreement), including: (a) increased unit amount outsourced per external fund manager in order to attract interest of reputable firms; and (b) adoption of revised criteria for selecting and recontracting external fund managers to reflect diversification of investment risks. Commitment to: (a) phase out per agreed timetable all lending from NPF to program participants using their contributions as collateral; and (b) refrain from providing financial assistance from NPF to restructuring of financially distressed corporations

Note: Unless otherwise indicated, actions related to the first tranche release will have been implemented before presentation of the loan to the Executive Directors and actions related to the second tranche release will have been implemented before the release of the second tranche.

KOREA: SECOND STRUCTURAL ADJUSTMENT LOAN

ATTACHMENT TO POLICY MATRIX
CONDITIONS FOR BOARD PRESENTATION AND SECOND TRANCHE RELEASE

The full program of policy actions to be supported by SAL II is set out in the SAL II Policy Matrix. Within this full program, a subset of key policy actions has been identified whose implementation will be a condition for Board presentation and second tranche release. Besides these specific policy actions, a general condition will be that the implementation of the full program is satisfactory overall.

Conditions for Board Presentation

Within the full program detailed in the policy Matrix, the following will serve as conditions for Board presentation:

- Adoption of objectives and principles acceptable to the Bank to be used by the Government in making decisions on the implementation plans of the seven undercapitalized banks, and other banks so identified, including the provision of financial support by the Government.

- Agreement between the Government and the lead manager selected for the privatization of Korea First Bank and Seoul Bank on the general deal structure (including confirmation to the Bank of the modalities of provision of public support), and authorization to the lead manager to contact investors.

- Adoption of principles acceptable to the Bank governing the use of public resources in financial system restructuring and recapitalization.

- Issuance of guidelines to financial institutions by FSC, satisfactory to the Bank, limiting the extension of "emergency" loans to corporations.

- Commitment to establish an independent accounting standard setting organization by June 1999.

- Adoption and announcement of an overall strategy acceptable to the Bank for dealing with structural, regulatory and institutional issues in privatization and SOE reform in infrastructure sectors, including, inter alia, the priority to be given to transition toward more competitive market structures and establishment of appropriate regulatory structures, and sequencing of structural, regulatory and ownership reforms.

- Extension of unemployment insurance to firms with fewer than five workers and to temporary and part-time workers, with effect from October 1998.

- Adoption and announcement of a timetable agreed with the Bank for the reduction of forced government appropriation of the flow of National Pension Fund surpluses, and announcement of the Government's commitment that the stock of its outstanding borrowings from NPF will be repaid in full at maturity without rollovers.

Conditions for Second Tranche Release

Within the full program detailed in the Policy Matrix, the following will serve as conditions for release of the second tranche, in addition to the general requirement of overall satisfactory progress in carrying out the full program.

- Maintenance of a sound macroeconomic framework, consistent with the objectives of the Program, as determined on the basis of indicators agreed to by the Borrower and the Bank.

- In consultation with the Bank, adoption of process and principles necessary to ensure that adequate public resources will be made available by the Government for use in financial system recapitalization and restructuring.

- Achievement of progress, satisfactory to the Bank, toward sale by the Government of majority ownership in Korea First Bank and Seoul Bank through a biding process satisfactory to the Bank.

- Adoption by KAMCO of principles, acceptable to the Bank, for the disposition of troubled assets acquired by KAMCO, including the sale of a majority of assets within three years of acquisition. Adoption of procedures, sources and instruments of funding for KAMCO acceptable to the Bank.

- (a) Adoption and issuance by FSC of improved accounting and auditing standards for financial institutions, listed companies and joint stock companies consistent with international best practice and prepared with participation of representatives of internationally recognized accounting firms, and institution and announcement of the requirement that financial statements of financial institutions, listed companies, and joint stock companies with assets in excess of W7 billion will be prepared and audited in accordance with these standards from fiscal year 1999. (b) Adoption and announcement of an implementation plan acceptable to the Bank for the establishment of an independent accounting standard setting organization by June 1999.

- Adoption and announcement of a plan and schedule acceptable to the Bank for the institution of a requirement for the establishment by listed companies of audit committees of boards of directors, and completion of a draft of necessary changes in laws and regulations to give effect to this requirement.

- Enactment of amendments to the Fair Trade Act, acceptable to the Bank, to enhance competition in the domestic economy, based on the recommendations of the Joint Public/Private Sector Committee.

- Enactment of the Act on Comprehensive Regulation of Cartels.

- Enactment of legislation, satisfactory to the Bank, modifying restrictions under the Fair Trade Act on the creation of holding company structures so as to permit such structures subject to conditions to avoid undue ownership concentration.

- Achievement of progress, satisfactory to the Bank, on enhancement of labor market flexibility.

- Allocation of amounts in the 1999 budget sufficient to: (a) expand the public works program to absorb the supply of labor forthcoming at targeted wage levels (not higher in real terms than under Phase II of this program); (b) expand the provision of means-tested non-contributory income support for the unemployed poor in line with the increase in the eligible target group; (c) expand workfare and other forms of income support for able-bodied beneficiaries of "self-support" under the livelihood protection program; and (d) at least maintain in real terms the level of expenditure per beneficiary under the existing livelihood protection programs for the poor.

- Implementation of the phased reduction of forced government appropriations from the National Pension Fund agreed with the Bank, through adoption of legislation satisfactory to the Bank, including necessary revisions to the Public Fund Management Act.

ANNEX 2
STATISTICS

Table 1. Korea: Macroeconomic Framework, 1992-98

	1992	1993	1994	1995	1996	1997 Est.	1998 Proj.
Real GDP growth (percent change)	5.1	5.8	8.6	8.9	7.1	5.5	-5.0 2/
Consumption	6.8	5.3	7.0	7.2	6.9	3.5	-10.3
Gross fixed investment	-0.8	5.3	12.0	11.7	7.1	-3.5	-30.6
Stockbuilding 1/	-0.5	-1.0	1.4	-0.5	1.2	-3.7	-3.9
Net exports 1/	1.7	1.4	-1.7	0.5	-0.8	8.6	15.8
Saving and investment (in percent of GDP)							
Gross domestic investment	36.6	35.1	35.8	37.0	38.4	35.0	22.4
Gross national saving	35.3	35.4	34.8	35.2	33.7	33.1	34.3
Current account balance	-1.3	0.3	-1.0	-1.9	-4.7	-1.9	11.9
Prices (percent change)							
Average CPI inflation	6.2	4.8	6.3	4.5	4.9	4.5	8.5
End-period CPI inflation	4.6	5.8	5.6	4.7	4.9	6.6	7.2
GDP deflator	6.1	5.1	5.5	5.6	3.4	2.4	6.1
Exchange rate (Won/U.S.$) (ave.)	780.7	802.7	803.5	771.3	804.5	951.3	..
Consolidated central government (in percent of GDP)							
Revenues	18.2	19.3	20.2	20.7	21.9	22.0	23.0
Expenditures 3/	18.9	19.0	19.7	20.3	21.6	21.9	28.1
Overall balance	-0.7	0.3	0.5	0.3	0.3	0.1	-5.1
Money and credit (end of period)							
M3 growth	21.8	19.0	24.7	19.1	16.7	13.9	13.5
Reserve money growth	10.9	27.5	9.2	16.3	-12.2	-12.5	13.9
Three-year corporate bond yield	16.2	12.6	12.9	11.7	12.6	24.3	..
Trade (percent change)							
Export volume	8.1	7.0	14.8	24.0	19.8	24.9	17.8
Import volume	2.0	1.4	21.5	21.3	12.7	1.5	-19.6
Terms of trade	0.3	-1.1	1.5	-3.5	-12.3	-11.3	-3.3
Balance of payments (in billions of US$)							
Exports, f.o.b.	76.2	82.1	95.0	124.6	130.0	138.6	139.5
Imports, f.o.b.	-78.0	-79.8	-97.8	-129.1	-144.9	-141.8	-99.2
Current account balance	-3.9	1.0	-3.9	-8.5	-23.0	-8.2	35.0
Usable reserves import cover 4/	2.2	2.6	2.6	2.4	2.0	0.6	4.1
External debt (billions of US$)							
Total external debt 5/	..	67.0	88.7	119.7	157.5	154.4	153.8
Of which: Short-term	..	40.3	58.4	78.7	100.0	68.4	43.0
External debt in percent of GDP	..	20.1	23.3	26.2	32.5	34.4	52.1

Source: Bank of Korea
1/ Contribution to GDP.
2/ In the light of more recent developments, growth forecasts are being revised. For 1998, a decline in GDP of around 7% now appears more likely.
3/ Including bank restructuring costs and additional unemployment-related expenditures agreed to under the Tripartite Accord.
4/ Months of imports of goods and nonfactor services; excludes BOK deposits at overseas branches and subsidiaries of Korean banks.
5/ Includes offshore borrowing of domestic financial institutions and debt contracted by overseas branches of domestic financial institutions.

Table 2. Korea: Balance of Payments and Financing Requirements, 1993-98
(In billions of U.S. dollars)

	1993	1994	1995	1996	1997 Est.	1998 Proj.
Current account balance	**1.0**	**-3.9**	**-8.5**	**-23.0**	**-8.2**	**35.0** 1/
Trade balance	2.3	-2.9	-4.4	-15.0	-3.2	40.3
Exports	82.1	95.0	124.6	130.0	138.6	139.5
Imports	79.8	97.8	129.1	144.9	141.8	99.2
Services, income and transfers (net)	-1.3	-1.0	-4.1	-8.0	-5.0	-5.3
Capital account balance	**2.0**	**8.5**	**15.6**	**23.9**	**-28.0**	**-14.9**
Direct investment (net)	-0.8	-1.7	-1.8	-2.3	-1.6	0.4
Equity securities (net)	6.4	3.2	4.0	5.3	-1.3	3.1
Net official borrowing	-1.8	-0.3	-0.5	-0.5	-0.2	-0.6
Net private medium and long-term capital 2/ 3/	2.2	2.0	8.2	11.3	14.6	16.9
Trade credits	-1.0	2.7	3.1	3.7	-2.5	-10.0
Net private short-term capital 4/ 5/	1.6	8.5	10.7	11.8	-28.7	-22.2
Deposits/currency	-1.3	-1.6	-1.7	-2.6	0.1	0.3
Other	-3.4	-4.5	-5.3	-3.9	-3.4	0.7
Errors and omissions	-0.7	-1.8	-1.2	1.1	-5.1	-3.3
Overall balance	**3.0**	**4.6**	**7.0**	**0.9**	**-36.1**	**20.1**
Financing	..	..	..	..	**15.8**	**13.8**
IMF purchases/repurchases 6/	..	..	..	..	10.9	5.1
World Bank/ADB funding	..	..	..	..	4.9	4.7
Support from official bilateral creditors	..	..	..	..	0.0	0.0
Market borrowing by government	..	..	..	..	0.0	4.0
Remaining financing gap	..	..	..	..	0.0	0.0
Change in usable reserves (- increase) 7/	**-3.0**	**-4.6**	**-7.0**	**-0.9**	**20.3**	**-33.9**
Memorandum items:						
Current account balance (as a percent of GDP)	0.3	-1.0	-1.9	-4.7	-1.9	11.9
Usable gross reserves	20.2	25.6	28.5	29.4	9.1	43.0
Usable reserve cover (months of imports of goods and nonfactor services) 7/	2.6	2.6	2.4	2.0	0.6	4.1
Ratio of short-term debt to usable reserves 8/	2.0	2.3	2.8	3.4	7.5	1.0

Source: Bank of Korea

1/ In the light of more recent developments, the balance of payments forecast for 1998 is being revised. A current account surplus of $37-40 billion now seems more likely.

2/ Includes domestic financial institutions. $22 billion of financial institutions' short-term debt was converted to medium term loans in April 1998.

3/ Assumes 100 percent rollover of corporate debt in 1998.

4/ Including $22 billion of financial institutions' short-term debt converted to medium-term loans in April 1998.

5/ Adjusted upward to include the impact of foreign currency liquidity support by the Bank of Korea to overseas branches of DMBs in 1995-97.

6/ Gross purchases from IMF in 1998 are programmed at $7.9 billion.

7/ Adjusted to exclude the impact of foreign currency liquidity support by the Bank of Korea to overseas branches of DMBs.

8/ Including IMF, offshore borrowing of domestic financial institutions and debt contracted by overseas branches of domestic financial institutions.

Table 3. Korea: Summary of Consolidated Central Government Operations, 1992-98

	1992	1993	1994	1995	1996	1997 Est.	1998 Proj.
			(In trillions of won)				
Total revenue	**43.8**	**51.5**	**61.7**	**72.8**	**85.5**	**92.6**	**97.4**
Tax revenue	35.4	39.4	47.2	56.8	65.0	69.9	68.6
Social security contributions	2.4	4.1	4.6	5.4	7.4	8.3	10.6
Nontax revenue and capital income	6.0	8.0	9.9	10.6	13.1	14.5	18.2
Expenditures	**45.5**	**50.7**	**60.3**	**71.6**	**84.4**	**92.2**	**118.9**
Current expenditures	35.4	39.1	45.7	49.9	55.4	62.8	80.5
Capital expenditures and net lending	10.1	11.6	14.6	21.7	29.0	29.4	38.4
Overall consolidated central government balance	**-1.7**	**0.8**	**1.4**	**1.2**	**1.1**	**0.4**	**-21.5**
			(In percent of GDP)				
Total revenue	**18.2**	**19.3**	**20.2**	**20.7**	**21.9**	**22.0**	**23.0**
Tax revenue	14.7	14.8	15.4	16.1	16.7	16.6	16.2
Social security contributions	1.0	1.5	1.5	1.5	1.9	2.0	2.5
Nontax revenues and capital income	2.5	3.0	3.2	3.1	3.3	3.4	4.3
Expenditures	**18.9**	**19.0**	**19.7**	**20.3**	**21.6**	**21.9**	**28.1**
Current expenditures	14.7	14.6	14.9	14.2	14.2	14.9	19.0
Capital expenditures and net lending	4.2	4.3	4.8	6.1	7.4	7.0	9.1
Overall consolidated central government balance	**-0.7**	**0.3**	**0.5**	**0.3**	**0.3**	**0.1**	**-5.1**
Memorandum item:							
Nominal GDP (in trillion won)	240.4	267.1	306.0	352.0	390.0	421.0	423.6

Source: Ministry of Finance and Economy

Table 4. Korea: Reserve Money and Financial Survey, 1992-98
(In billions of won; end of period)

	1992	1993	1994	1995	1996	1997 Est.	1998 Proj.
Bank of Korea							
Net foreign assets 1/	13,530	16,395	20,303	25,419	24,940	-3,300	33,410
Assets	14,391	17,412	21,607	26,068	25,570	10,010	55,900
Liabilities	-861	-1,017	-1,304	-649	-630	-13,310	-22,490
Net domestic assets	4,577	6,684	4,901	3,886	782	25,819	-7,770
Public sector 2/	-1,403	-1,762	-3,197	-4,307	-3,991	2,266	9,479
Private financial sector	32,170	36,789	37,397	37,233	37,372	85,529	63,106
Other items	-26,190	-28,341	-29,298	-29,039	-32,599	-61,976	-80,355
Reserve money	18,107	23,080	25,204	29,306	25,722	22,519	25,640
Financial survey							
Net foreign assets	6,007	9,156	9,421	9,214	470	-21,049	18,541
Net domestic assets	292,271	345,777	433,242	517,803	614,491	721,333	776,281
Public sector 2/	8,764	11,248	11,383	8,979	9,616	8,899	9,060
Private sector	299,390	352,872	443,855	528,981	628,444	747,307	811,668
Other items 3/	-15,883	-18,343	-21,997	-20,157	-23,568	-34,873	-44,447
Total liquidity (M3)	298,277	354,933	442,663	527,017	614,962	700,284	794,822
Memorandum items:							
Reserve money 4/							
Twelve-month percent change	10.9	27.5	9.2	16.3	-12.2	-12.5	13.9
M3							
Twelve-month percent change	21.8	19.0	24.7	19.1	16.7	13.9	13.5

Source: Bank of Korea, *Monthly Statistical Bulletin.*

1/ 1997 figure is valued at program exchange rates; projections for 1998 are made under baseline assumptions about accumulation of foreign reserves and purchases/repurchases from the IMF.

2/ Government, government agencies and official entities.

3/ Decline in 1997 reflects Bank of Korea marking to market foreign currency denominated assets (including foreign exchange deposits at DMBs).

4/ Between April 1996 and February 1997, the (average) required reserve ratio was reduced from 9.4 percent to 3.3 percent.

Table 5. Korea: Stock of External Liabilities by Maturity and Borrower, 1995-98
(In billions of U.S. dollars)

	1995	1996	1997	July 1998
Short-Term Liabilities	**78.7**	**100.0**	**68.4**	**38.4**
I. Financial institutions	63.1	78.0	43.8	19.6
A. Domestic financial institutions 1/	52.1	65.2	28.9	10.8
Resident domestic financial institutions 2/	18.7	26.2	11.7	7.0
Offshore banking of domestic financial institutions 3/	8.4	12.7	8.7	1.2
Overseas branches and subsidiaries of domestic financial institutions 4/	25.0	26.4	8.5	2.6
B. Branches of foreign banks 5/	11.0	12.8	14.9	8.8
II. Domestic corporations 6/ 7/	15.6	22.0	24.7	18.8
Medium and Long-Term Liabilities	**41.0**	**57.5**	**86.0**	**113.9**
I. Financial institutions	27.5	41.5	50.4	63.2
A. Domestic financial institutions 1/	25.5	38.3	46.4	57.3
Resident domestic financial institutions 2/	17.6	24.5	29.9	34.2
Offshore banking of domestic financial institutions 3/	4.2	8.5	9.2	14.3
Overseas branches and subsidiaries of domestic financial institutions 4/	3.7	5.3	7.3	8.8
B. Branches of foreign banks 5/	2.0	3.2	4.0	5.9
II. Domestic corporations 6/ 7/	10.5	13.6	17.6	20.0
III. Public sector	3.0	2.4	18.0	30.7
Total External Liabilities	**119.7**	**157.5**	**154.4**	**152.3**

Source: Bank of Korea, and Ministry of Finance and Economy.
1/ Includes commercial banks, specialized banks, merchant banks, and development institutions.
2/ Includes commercial paper, call money, refinance, and term loans.
3/ Domestic financial institutions' short-term offshore borrowings, excluding interoffice account borrowings.
4/ Domestic financial institutions' overseas branches and subsidiaries excluding interoffice accounts.
The data in the table exclude the nonresident deposits in the overseas branches and subsidiaries of domestic financial institutions.
5/ Includes nonresident deposits, call money, refinance, term loan and interoffice account borrowings.
6/ Includes trade credit, loans for oil imports, and advance receipts of exports.
7/ In line with international standards, these data exclude nonresident subsidiaries of Korean corporations.

Table 6. Korea: Medium-Term Projections, 1998-2003

	1997	1998	1999	2000	2001	2002	2003
National Accounts (percent change)							
Total consumption	3.5	-10.3	-0.6	2.2	4.0	4.5	5.1
Gross fixed investment	-3.5	-30.6	3.6	6.5	9.0	7.7	7.9
Total domestic demand	-2.8	-22.2	1.4	4.5	6.0	6.0	6.4
Net exports 1/	8.6	15.7	-1.1	-0.5	0.2	0.9	0.8
Gross domestic product	5.5	-5.0 2/	0.0 2/	3.0	4.9	5.6	6.0
Consumer prices (percent change)	4.5	8.5	4.3	4.0	3.5	3.1	3.1
Savings and investment (percent of GDP)							
Gross national savings	33.1	34.3	32.8	32.5	32.9	33.7	34.5
Gross domestic investment	35.0	22.4	26.9	28.7	30.4	31.7	32.8
Current account balance	-1.9	11.9	5.9	3.8	2.5	2.0	1.7
Trade (percent change)							
Merchandise exports	6.7	0.6	3.3	6.0	7.6	7.7	8.1
Volumes 3/	24.9	17.8	7.0	7.1	7.4	7.4	7.4
Merchandise imports	-2.2	-30.1	15.6	12.2	11.0	10.2	10.2
Volumes 3/	1.5	-19.7	14.8	12.7	11.0	9.8	9.7
Terms of trade	-11.3	-1.3	-4.1	-0.7	0.1	-0.2	0.2
Balance of Payments (in billion U.S.$)							
Merchandise exports	138.6	139.5	144.0	152.6	164.2	176.8	191.2
Merchandise imports	-141.8	-99.2	-114.7	-128.7	-142.9	-157.5	-173.6
Trade balance	-3.2	40.3	29.3	23.9	21.3	19.3	17.6
Current account	-8.2	35.0 2/	19.8	13.5	9.7	8.7	8.1
Usable gross reserves	9.1	43.0	64.9	76.0	87.4	100.1	114.5
In months of imports 4/	0.6	4.1	5.4	5.8	6.0	6.2	6.5
External debt (U.S.$ billion) 5/	154.4	153.8	154.1	159.2	161.9	164.9	169.9
In percent of GDP	34.9	51.2	46.3	44.8	41.3	38.4	36.1
Short-term external debt (U.S.$ billion) 5/	68.4	43.0	44.5	47.0	49.8	52.5	54.1
Ratio to usable reserves	7.5	1.0	0.7	0.6	0.6	0.5	0.5
Debt service ratio 6/	8.9	8.9	12.9	9.4	8.7	7.8	7.5
Consolidated central government (in percent of GDP)							
Revenues	22.0	23.0	23.3	23.4	23.6	23.8	24.0
Expenditures 7/	21.9	28.1	28.3	27.0	26.4	26.1	25.9
Overall balance	0.1	-5.1	-5.0	-3.6	-2.8	-2.3	-1.9
Government debt 8/	13.6	28.0	39.0	40.7	40.4	39.8	38.8

Source: Bank of Korea and International Monetary Fund.
1/ Contribution to GDP.
2/ In the light of more recent developments, growth forecasts are being revised. For 1998 and 1999, declines in GDP of around 7% and 1%, respectively, now appear more likely. Also, the current account surplus for 1998 is being revised upwards to $37-40 billion.
3/ Customs clearance basis.
4/ Goods and nonfactor services.
5/ Including IMF, offshore borrowing of domestic financial institutions and debt contracted by overseas branches of domestic financial institutions.
6/ Medium- and long-term debt; in percent of exports of goods and nonfactor services.
7/ Includes bank restructuring costs and additional unemployment-related expenditures.
8/ Includes bonds issued for bank restructuring.

Table 7. Korea: Assets of the Financial System, 1993-97

	1993	1995	1997	1997 (In percent of total financial system assets)
	(In trillions of won)			
Deposit Money Banks	**408.7**	**591.5**	**861.7**	**57.9**
Nation-wide Commercial Banks	151.0	225.0	379.0	25.5
Trust Accounts of commercial banks 1/	133.1	212.1	288.0	19.3
Local Commercial Banks	29.3	44.2	58.7	3.9
Foreign Banks	14.6	19.4	45.8	3.1
Specialized Banks 2/	80.7	90.8	90.2	6.1
Nonbank Financial Institutions	**229.8**	**316.2**	**492.0**	**33.0**
Development Institutions	51.8	70.5	149.0	10.0
Korea Development Bank	35.9	47.8	106.1	7.1
Export Import Bank of Korea	4.4	6.7	21.4	1.4
Korea Long-Term Credit Bank	11.5	16.0	21.5	1.4
Investment Institutions	97.4	130.2	186.6	12.5
Merchant Banks	33.1	45.9	77.6	5.2
Investment Trust Companies	59.1	76.0	102.6	6.9
Korea Securities Finance Corporation	5.2	8.3	6.4	0.4
Savings Institutions	80.6	115.5	156.4	10.5
Mutual Credits	28.7	42.0	62.0	4.2
Mutual Savings and Finance Companies	23.4	32.6	36.0	2.4
Credit Unions	8.5	13.2	19.3	1.3
Community Credit Cooperatives	14.4	20.7	29.8	2.0
Postal Savings and Postal Life Insurance	5.6	7.0	9.3	0.6
Contractual Savings Institutions	**65.7**	**94.0**	**135.0**	**9.1**
Life Insurance Companies	48.8	67.0	92.5	6.2
Loans	24.6	31.7	44.6	3.0
Securities	13.8	18.9	23.0	1.5
Others	10.4	16.4	24.9	1.7
Pension Funds 3/	16.9	27.0	42.5 4/	2.9
Loans	6.5	14.0	24.9	1.7
Securities	7.0	8.1	9.3	0.6
Others	3.4	4.9	8.3	0.6
Total Financial System	**704.2**	**1,001.7**	**1,488.7**	**100.0**

Sources: Bank of Korea, National Pension System, Korea Teacher's Pension Corporation, Government Employees Pension Corporation, Ministry of Defense, and OECD *Institutional Investors 1997.*

1/ Trust account business is carried out by the commercial banks but classified by the BOK as non-bank financial intermediation.

2/ Korea Housing Bank became a commercial bank in August 1997.

3/ Includes the National Pension System, Korea Teacher's Pension, Military Pension, Government Employees Pension and Korean Teacher's Mutual Fund.

4/ Actual for the National Pension System and estimates for the other funds.

ANNEX 2

Table 8: Korea: Summary of Privatization and Restructuring Plans for Major SOEs Announced in July and August 1998

Enterprise	Revenue (in billion Won)	Employees	Gov't Ownership (%)	Privatization and Restructuring Plan
Infrastructure and Related Enterprises				
Korea Electric Power Corp	13,400.0	34,879	58.2	Divest from unrelated businesses and contract-out construction of new power plants (other than nuclear) and co-generation plants. By end-October 1997, complete plan to restructure the industry. By end-1998, sell 5% of common shares; In 1999, sell a fixed number of existing power plants.
Korea Telecom Corp	7,785.2	58,556	71.2	Resctructure business operations. Sell or contract-out satellite communications and telegram services; withdraw from 8 business areas. Before end 2000: issue 10% of new shares to strategic investor; international public offering of up to 18%; partial offering to employees and institutional investors. After 2000: sell 33.4% of remaining shares.
Korea Gas Corp	2,926.6	2,891	50.2	Restructure KOGAS and promote competition in the gas industry. Contract-out non-core business activities. By 1999, complete public offering of shares in magnitude of 250 b.w. By 2000, introduce open access system. By 2002, complete privatization.
Korea District Heating Corp	202.6	1,001	46.1	Focus on core business, reorganize business units and reduce workforce. In 1999, sell two co-gen plants. By 2001, sell 51% or more of shares.
Daehan Oil Pipeline Corp	33.6	386	48.8	Improve competitiveness, operate branches as separate accounting centers, and adopt early retirement plan. Divest government equity by 2000.

ANNEX 2

Enterprise	Revenue (in billion Won)	Employees	Gov't Ownership (%)	Privatization and Restructuring Plan
Other Enterprises				
Pohang Iron and Steel Corp	9,718.1	19,294	3.1 (plus 23.57 held indirectly)	Sell 26.7% of shares, subject to 3% individual ownership limitation until 2001.
Korea Heavy Industries & Construction Corp	3,070	7,851	n.a. (held indirectly)	Fully privatize: international open bidding, plus sale to employees.
Korea Tobacco & Ginseng Corp	4,243.4	7,573	35.3	Undertake comprehensive restructuring. Separate ginseng business from cigarette business by end 1998. Dramatically reduce number of cigarette manufacturing and leaf processing plants and sell non-operating plants. In 1998 and 1999, sell 25% of shares to domestic and foreign investors, with special allotment to employees and an individual ownership limitation of 7%; In 2000, remove individual ownership limitation and monopoly over cigarette production.
Korea Technology Banking Corp	438.4	163	10.2	Sale through open bidding.
National Textbook Corp	51.7	739	40 (plus 46.5% indirect)	By end-1998, full divestiture.
Korea General Chemistry Corp	14	275	n.a. (98.8 held indirectly)	Dispose of shares in Namhae Chemical Corp. through trade sale. Sell remaining assets of KGCC.

KOREA: SECOND STRUCTURAL ADJUSTMENT LOAN

ANNEX 3

IBRD Loans and IDA Credits in the Operations Portfolio

Project ID	Loan or Credit No.	Fiscal Year	Borrower	Purpose	Original amount in $ million: IBRD	IDA	Canceled	Undisb.	Difference between expected and actual disbursements [a/]: Orig.	Frm Rev'd	Last ARPP upervision rating [b/]: Dev Obj	Imp Prog
Number of Closed Loans/Credits: 124												
Active Loans												
KR-PE-4170	IBRD 36130	1993	Rep. of Korea	Ptrl Dist & Sec Mgmt.	120.0	0.0	0.0	19.8	19.8	19.8	S	S
KR-PE-4171	IBRD 36120	1993	Rep. of Korea	Environ. Research & Engr.	60.0	0.0	0.0	7.5	8.3	0.0	HS	HS
KR-PE-4169	IBRD 35900	1993	Rep. of Korea	Seoul & Kwangju Sewerage	110.0	0.0	64.4	9.8	74.2	-0.8	S	S
KR-PE-4174	IBRD 36940	1994	Rep. of Korea	Environment Technology Dev.	90.0	0.0	0.0	5.2	7.3	0.0	HS	S
KR-PE-4168	IBRD 36930	1994	Rep. of Korea	Science & Technology Educ. Sector	190.0	0.0	0.0	33.1	3.4	0.0	HS	HS
KR-PE-4172	IBRD 36890	1994	Rep. of Korea	Financial Intermediation	100.0	0.0	0.2	1.1	1.3	0.7	S	S
KR-PE-35079	IBRD 38300	1995	Rep. of Korea	Waste Disposal Project	75.0	0.0	0.0	55.5	41.0	0.0	S	S
KR-PE-4175	IBRD 38280	1995	Rep. of Korea	Pusan Urban Transp. & Mgmt.	100.0	0.0	0.0	34.9	23.2	0.0	HS	HS
KR-PE-4173	IBRD 37930	1995	Rep. of Korea	Ports Development & Environment	100.0	0.0	3.1	55.9	47.7	0.0	S	S
KR-PE-56796	IBRD 43850	1999	Rep. of Korea	Fin. and Corp. Restructuring	48.0	0.0	0.0	48.0	0.0	0.0		
Total					**993.0**	**0.0**	**67.6**	**270.7**	**226.2**	**19.7**		

	Active Loans	Closed Loans	Total Loans
Total Disbursed (IBRD and IDA):	655	12,185	12,840
of which has been repaid:	0	6,228	6,228
Total now held by IBRD and IDA:	925	5,957	6,882
Amount Sold:	0	132	132
of which repaid:	0	132	132
Total Undisbursed:	271	0	271

a/ Intended disbursements to date minus actual disbursements to date as projected at appraisal.

b/ Following the FY94 Annual Review of Portfolio Performance (ARPP), a letter based system was introduced (HS = highly satisfactory, S = satisfactory, U = unsatisfactory, HU = highly unsatisfactory): see Proposed Improvements in Project and Portfolio Performance Rating Methodology (SecM94-901), August 23, 1994.

Korea: Statement of IFC'S Committed and Disbursed Portfolio
(In US$ million)

		Committed				Disbursed			
FY Approval	Company	Loan	Equity	Quasi	Partic	Loan	Equity	Quasi	Partic
1968/74/76/77/78/80/ 90/94/98	KLTCB	0.0	15.1	25.0	0.0	0.0	15.1	25.0	0.0
1971/74/76/79/80/82/85/89/ 91/94/97/00	Hana Bank	20.0	21.6	30.0	0.0	0.0	21.6	30.0	0.0
1974/76/77/79/80/84/85/ 87/88/89/91/92/93/96	LG Electronics	0.0	11.4	0.0	0.0	0.0	11.4	0.0	0.0
1977/79/87/90	KDLC	0.0	1.2	0.0	0.0	0.0	1.2	0.0	0.0
1983/91	KDIC	0.0	1.7	0.0	0.0	0.0	1.7	0.0	0.0
1985	KDIC-Seoshin	0.0	0.3	0.0	0.0	0.0	0.3	0.0	0.0
1985	KDIC-SK Chemical	0.0	0.1	0.0	0.0	0.0	0.1	0.0	0.0
	Total Portfolio:	**20.0**	**51.5**	**55.0**	**0.0**	**0.0**	**51.5**	**55.0**	**0.0**

		Approvals Pending Commitment			
		Loan	Equity	Quasi	Partic
1998	H & Q Korea	0.0	30.0	0.0	0.0
1998	Hana Bank	0.0	21.9	0.0	0.0
	Total Pending Commitment	**0.0**	**51.9**	**0.0**	**0.0**

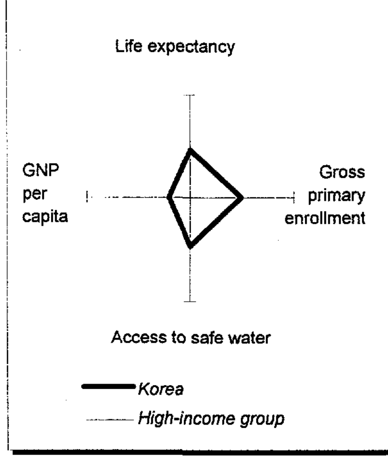
KOREA: SECOND STRUCTURAL ADJUSTMENT LOAN

ANNEX 4

Korea at a glance

POVERTY and SOCIAL	Korea	East Asia & Pacific	High-income
1997			
Population, mid-year *(millions)*	46.0	1,753	926
GNP per capita *(Atlas method, US$)*	10,550	970	25,700
GNP *(Atlas method, US$ billions)*	485.3	1,707	23,802
Average annual growth, 1991-97			
Population *(%)*	1.0	1.3	0.7
Labor force *(%)*	1.9	1.4	0.9
Most recent estimate (latest year available, 1991-97)			
Poverty *(% of population below national poverty line)*	..	..	..
Urban population *(% of total population)*	83	32	76
Life expectancy at birth *(years)*	72	69	78
Infant mortality *(per 1,000 live births)*	9	38	6
Child malnutrition *(% of children under 5)*	..	16	..
Access to safe water *(% of population)*	89	84	94
Illiteracy *(% of population age 15+)*	2	17	< 5
Gross primary enrollment *(% of school-age population)*	101	115	103
Male	100	118	104
Female	101	116	103

Development diamond*

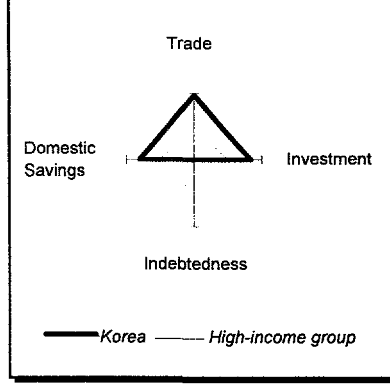


KEY ECONOMIC RATIOS and LONG-TERM TRENDS

	1976	1986	1996	1997
GDP *(US$ billions)*	29.1	108.6	484.6	442.5
Gross domestic investment/GDP	26.7	28.7	38.4	35.0
Exports of goods and services/GDP	31.0	37.6	32.4	38.1
Gross domestic savings/GDP	24.9	34.6	34.5	34.2
Gross national savings/GDP	24.2	32.9	33.7	33.1
Current account balance/GDP	-1.1	4.3	-4.7	-1.9
Interest payments/GDP	1.5	2.7	0.5	0.5
Total debt/GDP	35.5	43.0	32.5	34.9
Total debt service/exports	11.0	27.3	5.9	6.0
Present value of debt/GDP	..	..	..	..
Present value of debt/exports	..	..	..	..

	1976-86	1987-97	1996	1997	1998-02
(average annual growth)					
GDP	6.9	7.6	7.1	5.5	3.5
GNP per capita	5.2	6.5	5.5	3.9	2.8
Exports of goods and services	10.7	11.8	13.0	23.6	7.2

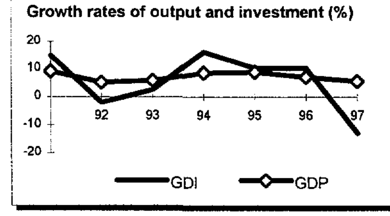
Economic ratios*



STRUCTURE of the ECONOMY

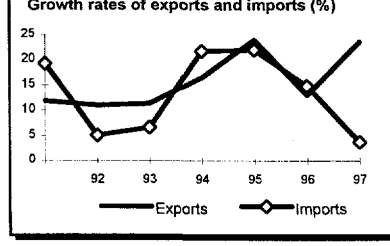
	1976	1986	1996	1997
(% of GDP)				
Agriculture	23.5	11.2	6.3	5.7
Industry	34.6	42.1	42.9	42.9
Manufacturing	27.4	30.8	25.9	25.7
Services	41.9	46.8	50.8	51.4
Private consumption	64.2	55.4	54.8	54.6
General government consumption	10.9	10.0	10.7	11.1
Imports of goods and services	32.8	31.7	36.3	38.8

Growth rates of output and investment (%)



	1976-86	1987-97	1996	1997
(average annual growth)				
Agriculture	1.4	1.3	4.0	2.5
Industry	10.1	8.3	7.4	5.6
Manufacturing	10.7	7.9	7.4	6.2
Services	6.8	8.1	7.2	5.9
Private consumption	6.2	7.9	6.8	3.1
General government consumption	4.0	5.9	7.8	5.7
Gross domestic investment	7.4	9.2	10.3	-12.8
Imports of goods and services	7.8	13.9	14.8	3.8
Gross national product	6.7	7.6	6.8	4.9

Growth rates of exports and imports (%)

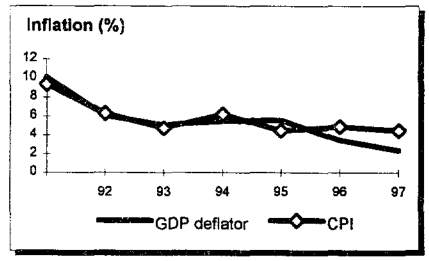


Note: 1997 data are preliminary estimates. Regional aggregate data exclude high-income economies.

* The diamonds show four key indicators in the country (in bold) compared with its income-group average. If data are missing, the diamond will be incomplete.

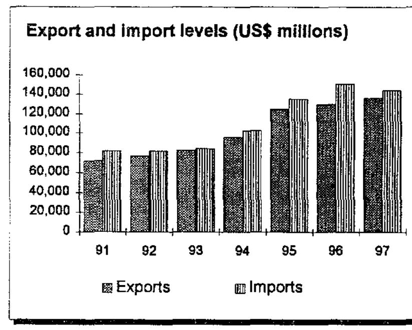
PRICES and GOVERNMENT FINANCE

	1976	1986	1996	1997
Domestic prices				
(% change)				
Consumer prices	15.4	2.8	4.9	4.5
Implicit GDP deflator	22.4	4.6	3.4	2.4
Government finance				
(% of GDP, includes current grants)				
Current revenue	16.0	16.4	19.3	19.5
Current budget balance	3.6	3.0	5.1	4.8
Overall surplus/deficit	-1.1	-0.1	0.3	0.1


Inflation (%)

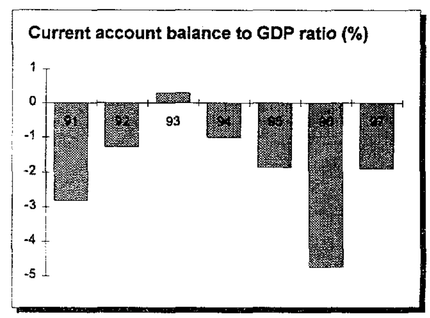
TRADE

	1976	1986	1996	1997
(US$ millions)				
Total exports (fob)	7,715	34,714	129,715	136,164
Mineral fuels	..	..	3,873	5,349
Chemicals	..	..	9,166	10,666
Manufactures	..	..	106,973	109,238
Total imports (cif)	8,774	31,584	150,339	144,166
Food	..	..	7,265	6,517
Fuel and energy	..	..	24,284	27,381
Capital goods	..	..	54,675	48,722
Export price index *(1995=100)*	69	102	87	73
Import price index *(1995=100)*	70	94	99	94
Terms of trade *(1995=100)*	99	109	88	78


Export and import levels (US$ millions)

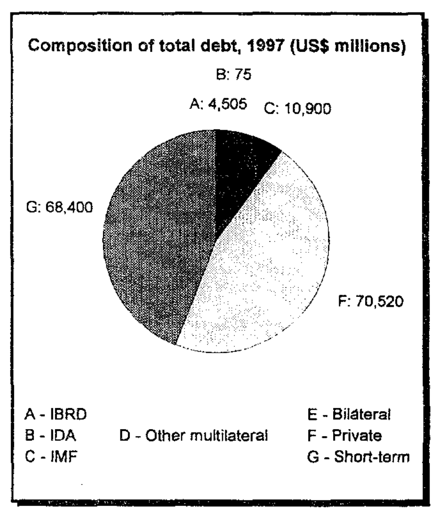
BALANCE of PAYMENTS

	1976	1986	1996	1997
(US$ millions)				
Exports of goods and services	9,341	39,409	153,380	164,921
Imports of goods and services	9,595	33,758	174,524	171,300
Resource balance	-254	5,651	-21,144	-6,379
Net income	-402	-2,310	-1,815	-2,454
Net current transfers	346	1,369	-46	667
Current account balance	-310	4,709	-23,005	-8,166
Financing items (net)	1,623	-4,755	23,905	-12,134
Changes in net reserves	-1,313	46	-900	20,300
Memo:				
Reserves including gold *(US$ millions)*	1,975	3,351	29,400	9,100
Conversion rate *(DEC, local/US$)*	484.0	881.5	804.5	951.3


Current account balance to GDP ratio (%)

EXTERNAL DEBT and RESOURCE FLOWS

	1976	1986	1996	1997
(US$ millions)				
Total debt outstanding and disbursed	10,347	46,725	157,500	154,400
IBRD	677	4,304	1,841	4,505
IDA	102	106	79	75
Total debt service	1,043	11,240	9,200	10,200
IBRD	50	798	527	535
IDA	1	2	4	4
Composition of net resource flows				
Official grants	..	..	..	..
Official creditors	..	..	..	..
Private creditors	..	..	..	..
Foreign direct investment	75	-767	-2,345	-1,605
Portfolio equity	0	-333	5,301	-1,300
World Bank program				
Commitments	372	562	0	3,000
Disbursements	286	332	210	3,161
Principal repayments	12	434	386	363
Net flows	273	-102	-176	2,798
Interest payments	38	364	141	172
Net transfers	235	-467	-316	2,626


Composition of total debt, 1997 (US$ millions)